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Inside IFRS : accounting and financial reporting fundamentals

Renee Rampulla

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Preface

This publication is intended to provide accounting and reporting guidance to practitioners and preparers of financial statements who are required to report under International Financial Reporting Standards (IFRSs).

Unless otherwise indicated, references to IFRSs throughout this inaugural edition of *Inside IFRS: Accounting and Financial Reporting Fundamentals* refer to the version of those standards and interpretations included in *2013 IFRS Consolidated Without Early Application* (commonly known as the Blue Book), that are required for annual reporting periods beginning on or after January 1, 2013. When necessary, author's notes provide information about newly issued standards and interpretations that are effective at a later date.

This publication is nonauthoritative and is not designed to provide a comprehensive understanding of all the requirements contained in IFRSs. In addition, this book does not address audit requirements or other matters, such as internal control or agreed upon procedures. Authoritative guidance on accounting treatments in accordance with IFRSs can only be made by reference to the IFRSs themselves, which are copyright of the International Accounting Standards Committee Foundation and can be acquired directly from the International Accounting Standards Board (IASB).

This book has not been reviewed, approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA and does not represent official positions or pronouncements of the AICPA. The use of this publication requires the exercise of individual professional judgment. It is not a substitute for the original authoritative pronouncements. Users are urged to refer directly to applicable authoritative pronouncements when appropriate. As an additional resource, users may call the AICPA Technical Hotline at 877.242.7212.

This book is geared towards providing readers an understanding of the accounting and reporting requirements as prescribed by IFRSs. The chapters herein are laid out in a topical format with a narrowed focus on specific IFRS pronouncements including IFRSs, International Accounting Standards, International Financial Reporting Interpretations Committee and Standing Interpretation Committee topics. The content includes recognition, measurement, presentation, and disclosure requirements by accounting topic, which allows the reader to gain an understanding of the respective accounting and disclosure requirements as prescribed by the IASB.

IFRS Financial Statements—Best Practices in Presentation and Disclosure (product code IFRSATT12P) is a publication in the AICPA Accounting Trends & Techniques series that offers robust presentation and disclosure excerpts from companies across multiple industries and in various countries that report under IFRSs. Readers are encouraged to use this resource in conjunction with this book.

Recognition

The AICPA gratefully acknowledges Renee Rampulla, the original author of the content of this publication.

The AICPA gratefully acknowledges the invaluable assistance provided by Patricia Walters in updating and otherwise contributing to the issuance of this publication.

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Feedback

We hope that you find this inaugural edition of *Inside IFRS: Accounting and Financial Reporting Fundamentals* to be informative and useful. We encourage you to provide candid feedback on features you liked about this publication, as well as areas for improvement. Please direct feedback to Anjali Patel, using the following contact information. All feedback is greatly appreciated and kept strictly confidential.

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Chapter 1

First-Time Adoption of International Financial Reporting Standards

Overview

1.01 The objective of this chapter is to provide a suitable starting point for an entity's first-time adoption of International Financial Reporting Standards (IFRSs). The aim of this chapter is to ensure that an entity's first IFRS financial statements and its interim financial reports contain high quality information that is transparent for the users, comparable over all periods presented, and that the costs of the adoption of IFRSs by an entity do not exceed the benefits.

1.02 When an entity first adopts IFRSs, it is responsible for complying with each IFRS effective at the end of its first IFRS reporting period. This chapter explains how an entity recognizes and measures assets and liabilities under IFRSs, and details those items when IFRSs do not permit recognition. Additionally, this chapter describes the reclassification of items recognized under the entity's previous generally accepted accounting principles (GAAP), required disclosures explaining the transition from previous GAAP, and specific limited exemptions from these requirements for certain items.

Summary of Selective Accounting Guidance

1.03 IFRS 1, *First-time Adoption of International Financial Reporting Standards*, is the primary authoritative literature that relates to the accounting for an entity's first-time adoption of IFRSs. IFRS 1 is amended to accommodate first-time adoption requirements resulting from new or amended IFRSs and was most recently amended as a result of changes to IFRS 10, *Consolidated Financial Statements*; IFRS 11, *Joint Arrangements*; and IFRS 12, *Disclosure of Interests in Other Entities*, made in June 2012.

1.04 The requirements of the following documents are effective on or after January 1, 2013.

- IFRS 10: This standard supersedes International Accounting Standard (IAS) 27, *Consolidated and Separate Financial Statements, and Standing Interpretations Committee (SIC) 12, Consolidation—Special Purpose Entities.*
- IFRS 11: This standard supersedes IAS 31, *Interests in Joint Ventures, and SIC 13, Jointly Controlled Entities—Non-monetary Contributions by Venturers.*
- IFRS 12: This standard applies to entities that have an interest in a subsidiary, a joint arrangement, an associate, or an unconsolidated structured entity.
- IFRS 13, *Fair Value Measurement*: This standard defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurement.
- Revisions to IAS 19, *Employee Benefits*, IAS 27, and IAS 28, *Investments in Associates and Joint Ventures*:
  - IAS 19: This standard prescribes the accounting and disclosure by employers for employee benefits.
  - IAS 27: This standard has been revised as a result of IFRS 10 and IFRS 12.
  - IAS 28: This standard has been revised as a result of IFRS 11 and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.
- International Financial Reporting Interpretations Committee (IFRIC) 20, *Stripping Costs in the Production Phase of a Surface Mine*: This interpretation was issued in October 2011 and is effective for annual periods beginning on or after January 1, 2013. This interpretation is out of scope for this book.

- The following amendments also were issued since the 2013 edition of *IFRS Consolidated Without Early Application* (commonly known as the Blue Book) with an effective date of January 1, 2013:
  - *Government Loans*: Amendments to IFRS 1.
  - *Disclosures—Offsetting Financial Assets and Financial Liabilities*: Amendments to IFRS 7, *Financial Instruments: Disclosures.*
  - *Annual Improvements 2009–2011 Cycle*: Amendments to IFRS 1 and IAS 1, *Presentation of Financial Statements*; IAS 16, *Property, Plant and Equipment*; IAS 32, *Financial Instruments: Presentation*; and IAS 34, *Interim Financial Reporting.*

1.05 In contrast, the following amendments are effective for annual periods beginning on or after January 1, 2013, and are discussed in author's notes throughout this book, when applicable.

- IFRS 9, *Financial Instruments* (issued November 2009 and again in October 2010 with an effective date of January 1, 2015).
- *Offsetting Financial Assets and Financial Liabilities*: Amendments to IAS 32 that were issued in December 2011. The amendments are required to be applied for annual periods beginning on or after January 1, 2014, with earlier application permitted.
- *Investment Entities*: Amendments to IFRS 10, IFRS 12, and IAS 27 that were issued in October 2012. The amendments provide an exception to the consolidation requirements in IFRS 10 for investment entities and, instead, require investment entities to measure their investments in particular subsidiaries at fair value through profit or loss. The amendments also provide related disclosure and separate financial statement requirements for investment entities.

Scope and Scope Exceptions

1.06 The scope of this chapter and IFRS 1 applies to the following:

- An entity's first IFRS financial statements.
- Each interim financial report, if any, for part of the period covered by its first IFRS financial statements, in accordance with IAS 34. For guidance regarding interim financial statements, refer to chapter 31, "Interim Financial Reporting," of this book.

1.07 An entity should consider its first IFRS financial statements to be the first set of annual financial statements in which an entity adopts IFRSs and makes an explicit, unreserved statement about compliance with IFRSs. The entity should consider these financial statements to be its first IFRS financial statements even if the entity's previous financial statements were presented in one of the following ways:

- In accordance with national requirements that are not consistent with IFRSs in all respects; for example, the entity applied a jurisdictional statutory requirement for an item in those statements
- In accordance with national requirements inconsistent with IFRSs, but using some individual IFRSs to account for items for which national requirements do not exist
- In accordance with national requirements, with a reconciliation of some amounts to the amounts determined in accordance with IFRSs
- In conformity with IFRSs in all respects, except that the financial statements did not contain an explicit, unreserved statement that they complied with IFRSs
- Containing a statement of compliance with some, but not all, IFRSs, such as the use of a hybrid approach of IFRSs and national or jurisdictional requirements

1.08 Additionally, the entity should consider these financial statements to be the entity's first IFRS financial statements if

- the entity's financial statements were prepared in accordance with IFRSs for internal use only, without making them available to the entity's owners or any other external users.

- the entity prepared a reporting package that was in accordance with IFRSs for consolidation purposes without preparing a complete set of financial statements as defined in IAS 1.[1]
- the entity did not present financial statements for previous periods.

1.09 An entity should apply IFRS 1 the first time it adopts IFRSs. However, IFRS 1 and the guidance in this chapter do not apply in the following circumstances:

- When an entity stops presenting financial statements in accordance with national requirements having previously presented both those statements and a separate set of financial statements that contained an explicit, unreserved statement of compliance with IFRSs
- When an entity presented its previous year's financial statements in accordance with national requirements and those financial statements contained an explicit, unreserved statement of compliance with IFRSs
- When an entity presented its previous year's financial statements that contained an explicit, unreserved statement of compliance with IFRSs, even if the entity's auditors qualified the audit report on those financial statements

1.10 IFRS 1 and this chapter do not apply to the following:

- Changes in accounting policies made by an entity already applying IFRSs. An entity applies the requirements of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, to these changes in accounting policy. For guidance regarding the changes in accounting policies, refer to chapter 30, "Accounting Policies, Changes in Accounting Estimates, and Errors," of this book.
- Specific transitional requirements in other IFRSs.

Exceptions and Exemptions

1.11 A first-time adopter of IFRSs should apply all the guidance in IFRS 1, including the guidance in the appendixes, which are considered integral parts of IFRS 1. The following appendixes to IFRS 1 include definitions and specific, limited exceptions and exemptions from the requirements of IFRS 1.

- Appendix A: Defined terms, including *date of transition to IFRSs*, *deemed cost*, *fair value*, *first IFRS financial statements*, *first IFRS reporting period*, *first-time adopter*, *opening IFRS Statement of Financial Position*, *previous GAAP*.
- Appendix B: Exceptions to retrospective application of other IFRSs, which describes exceptions to the retrospective application of the following:
  - Derecognition of financial assets and financial liabilities
  - Hedge accounting
  - Noncontrolling interest
  - Government loans
- Appendix C: Exemptions for business combinations, which describes an entity's ability to elect to not apply the following:
  - IFRS 3, *Business Combinations*, retrospectively to past business combinations
  - IAS 21, *The Effects of Changes in Foreign Exchange Rates*, retrospectively to fair value adjustments and goodwill arising in business combinations that occurred before the date of transition to IFRSs
- Appendix D: Exemptions from other IFRSs, which provides that an entity may elect to use one or more of the following exemptions, but that the entity cannot apply these exemption by analogy to other items:
  - Share-based payment transactions
  - Insurance contracts

[1] For guidance regarding the presentation of financial statements, refer to chapter 2, "The *Conceptual Framework and Financial Statement Presentation*," of this book.

- Fair value or previous GAAP revaluation as deemed costs for property, plant, and equipment (PP&E), investment property, and intangible assets that meet certain criteria
- Leases
- Cumulative translation differences
- Investments in subsidiaries, joint ventures, and associates
- Assets and liabilities of subsidiaries, associates, and joint ventures
- Compound financial instruments
- Designation of previously recognized financial instruments
- Fair value measurement of financial assets or financial liabilities at initial recognition
- Decommissioning liabilities included in the cost of PP&E
- Financial assets or intangible assets accounted for in accordance with IFRIC 12, *Service Concession Arrangements*
- Borrowing costs
- Transfers of assets from customers
- Extinguishing financial liabilities with equity instruments
- Severe hyperinflation
- Joint arrangements
- Stripping costs in the production phase of a surface mine

1.12 An entity may elect to use one or more of the exemptions contained in appendixes C–D of IFRS 1, but an entity cannot apply these exemptions by analogy to other items.

1.13 The term *fair value* is defined in appendix A of IFRS 1. An entity should apply this definition and any other guidance that is more specific on the determination of fair value for the asset or liability in question that are described in appendixes C–D of IFRS 1. If more specific fair value guidance exists in other IFRSs, then the entity should apply that guidance. Fair values should reflect conditions that existed at the date for which they were determined.

Recognition and Measurement

Opening IFRS Statement of Financial Position

1.14 An entity begins its accounting in accordance with IFRSs when it prepares and presents an opening IFRS statement of financial position as of the date of transition to IFRSs. The date of transition to IFRSs is the beginning of the earliest period for which an entity presents full comparative information in accordance with IFRSs in its first IFRS financial statements.

1.15 An entity's opening IFRS statement of financial position should comply with each applicable IFRS, except for the following established exceptions to this principle:

- The prohibition against retrospective application of some aspects of other IFRSs described in appendix B of IFRS 1 and paragraphs 1.21–.24 of this chapter
- The exceptions granted from some requirements of other IFRSs described in appendixes C–D of IFRS 1

Accounting Policies

1.16 The entity should use the same accounting policies in its opening IFRS statement of financial position that it uses throughout all the periods presented in its first IFRS financial statements. An entity's first IFRS reporting period is when the entity's accounting policies comply with each IFRS effective at the end of the latest reporting period covered by the entity's first IFRS financial statements, except as permitted by the guidance in appendixes B–D of IFRS 1 and paragraphs 1.21–.24 of this chapter.

1.17 A first-time adopter may not apply different versions of IFRSs that were effective at earlier dates, but may apply a new IFRS that is not yet mandatory, but permits early application.

1.18 Except as specified in appendixes B–D of IFRS 1, the transitional provisions in other IFRSs apply to changes in accounting policies made by an entity already using IFRSs and do not apply to first-time adopters.

1.19 Except as specified in paragraphs 1.21–.24 of this chapter and appendixes B–D of IFRS 1, an entity's opening IFRS statement of financial position should

- recognize all assets and liabilities whose recognition is required by IFRSs.
- not recognize items as assets or liabilities when IFRSs do not permit such recognition.
- reclassify items that are recognized in accordance with previous GAAP as one type of asset, liability, or component of equity, but are a different type of asset, liability, or component of equity in accordance with IFRSs.
- apply the requirements of IFRSs in measuring all recognized assets and liabilities.

1.20 An entity may use different accounting policies in its opening IFRS statement of financial position that it used for the same date when it applied its previous GAAP. Therefore, an entity may need to adjust assets, liabilities, and equity items in its opening IFRS statement of financial position. IFRS 1 considers these adjustments to have occurred before the date of the entity's transition to IFRS. Therefore, the entity should recognize these adjustments directly in retained earnings or another category of equity, if appropriate, at the date of transition to IFRSs.

Estimates

1.21 At the date of transition to IFRSs, an entity's estimates in accordance with IFRSs should be consistent with the estimates it made for the same date in accordance with its previous GAAP, after adjustments to reflect any differences in accounting policies, unless those estimates were in error, as supported by objective evidence.

1.22 After the date of transition to IFRSs, an entity may receive information regarding the estimates it made under previous GAAP. This information is addressed in the same way an entity would address a nonadjusting event after the reporting period in accordance with IAS 10, *Events After the Reporting Period*.

1.23 At the date of transition to IFRSs, an entity may also need to make estimates that were not required under previous GAAP. To achieve consistency with IAS 10, these estimates should reflect conditions that existed at the date of transition to IFRSs, which include market conditions such as market prices, interest rates, or foreign exchange rates.

1.24 The accounting treatment for estimates in IFRS 1 applies to the opening statement of financial position and a comparative period presented in an entity's first IFRS financial statements, with references to the date of transition to IFRSs replaced by references to the end of that comparative period.

Presentation and Disclosure

1.25 IFRS 1 provides specific limited exemptions to the recognition and measurement of certain items, but it does not include exemptions from the presentation and disclosure requirements included other IFRSs.

Comparative Information

1.26 In accordance with IAS 1, an entity's first IFRS financial statements should include the following:

- At least three statements of financial position
- Two statements of profit or loss and other comprehensive income
- Two separate income statements if presented by the entity as described in paragraphs 81 and 85 of IAS 1 and chapter 2, "The *Conceptual Framework and Financial Statement Presentation*," of this book
- Two statements of cash flows

- Two statements of changes in equity
- Related notes including comparative information

Non-IFRS Comparative Information and Historical Summaries

1.27 When an entity presents full comparative information in accordance with IFRSs, it will sometimes present historical summaries of selected data for periods before the first period it adopted IFRSs, even though compliance with IFRS 1 does not require such historical summaries or selective data in order to comply with the recognition and measurement requirements of IFRSs. Additionally, an entity sometimes presents comparative information in accordance with previous GAAP along with the required IAS 1 comparative information. When an entity's financial statements contain historical summaries or comparative information that is in accordance with previous GAAP, the entity should

a. label the previous GAAP information prominently as not being prepared in accordance with IFRSs; and

b. disclose the nature of the main adjustments that would make it comply with IFRSs, but the entity need not quantify those adjustments.

Explanation of Transition to IFRSs

1.28 When an entity transitions from a previous GAAP to IFRSs, it should explain how the transition affects its reported financial position, financial performance, and cash flows.

Reconciliations

1.29 To explain the effect the transition to IFRSs had on its reported financial position, financial performance, and cash flows, an entity's first IFRS financial statements should include the following:

- Reconciliations of its equity previously reported in accordance with the previous GAAP to its equity reported in accordance with IFRSs for both of the following dates:
  - Date of transition to IFRSs.
  - The end of the latest period presented in the entity's most recent annual financial statements in accordance with the previous GAAP.
- Reconciliation to its total comprehensive income in accordance with IFRSs for the latest period in the entity's most recent annual financial statements. The reconciliation should begin with total comprehensive income in accordance with the previous GAAP for the same period or, if an entity did not report such a total, profit or loss under the previous GAAP.

1.30 Impairment losses recognized or reversed for the first time when an entity is preparing its opening IFRS statement of financial position are subject to the disclosure requirements of IAS 36, *Impairment of Assets*. IAS 36 requires that the recognition of those impairment losses or reversals occur in the period beginning with the date of transition to IFRSs.

1.31 To enable users to understand the material adjustments to the statement of financial position and statement of profit or loss and other comprehensive income, the required reconciliations described in paragraph 1.29 should provide sufficient detail. If a statement of cash flows is presented under an entity's previous GAAP, the entity should also explain the material adjustments to its statement of cash flows.

1.32 The required reconciliations in paragraph 1.29 should distinguish corrections of errors that the entity became aware of that were made under previous GAAP from a change in accounting policies.

1.33 Changes in accounting policies that occur when an entity first adopts IFRSs are not addressed in IAS 8. Consequently, the requirements in IAS 8 for disclosure about such changes do not apply to an entity's first IFRS financial statement. Therefore, an entity should explain any changes in its accounting policies or the use of exemptions described in this IFRS that occurred between its first IFRS interim financial report and its first IFRS financial statement in accordance with paragraph 1.28 of this chapter. It should also update the required reconciliations described in paragraph 1.29 when there is such a change in accounting policy.

1.34 When an entity does not present financial statements for previous periods, it should disclose that fact in its first IFRS financial statements.

Designation of Financial Assets or Financial Liabilities

1.35 In accordance with paragraph D19 in appendix D of IFRS 1, IFRS 1 permits an entity to designate a previously recognized financial asset or financial liability as one of the following:

- A financial asset or financial liability measured at fair value through profit or loss
- A financial asset as available for sale

1.36 An entity should disclose the fair value of any financial assets or financial liabilities at the date of designation and the classification and carrying amount of these financial assets and financial liabilities in the previous financial statements.

Use of Fair Value as Deemed Cost

1.37 IFRS 1 defines a *deemed cost* as an amount used as a surrogate for cost or depreciated cost at a given date. Subsequently, depreciation or amortization assumes that an entity initially recognized the asset or liability at the given date and that its cost was equal to the deemed cost.

1.38 When an entity uses fair value in its opening IFRS statement of financial position as deemed cost for an investment property, an item of PP&E, or an intangible item, it should disclose the following for each line item in the opening IFRS statement of financial position in its first IFRS financial statements:

- The aggregate of those fair values
- The aggregate adjustment to the carrying amounts reported under previous GAAP

Refer to paragraphs D5 and D7 in appendix D of IFRS 1 for additional guidance.

Use of Deemed Cost for Oil and Gas Assets

1.39 Paragraph 8A(b) in appendix D of IFRS 1 provides an exemption for oil and gas assets. If an entity elects this exemption, it should disclose that fact and the basis on which the carrying amounts for oil and gas assets determined under previous GAAP were allocated.

1.40 When an entity presents an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements, the interim financial report should explain the transition from the previous GAAP to IFRSs, as described in paragraphs 1.28–.29 of this chapter. In addition to the requirements of IAS 34, an entity should satisfy the following requirements:

- If an entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, each interim financial report should include the following:
  - A reconciliation of its equity in accordance with previous GAAP at the end of that comparable interim period to its equity under IFRSs at that date.
  - A reconciliation of its total comprehensive income in accordance with IFRSs for that comparable interim period, with current and year to date totals. The beginning of the reconciliation should be the total comprehensive income in accordance with previous GAAP for that period or, if an entity did not report such a total, profit or loss in accordance with previous GAAP.
- In addition to the preceding required reconciliations, the first interim financial report, in accordance with IAS 34, for part of the period covered by its first IFRS financial statements, should include the reconciliations described in paragraphs 1.29–.30 or cross-reference the required information to another published document that includes these reconciliations.

1.41 Interim financial reports in accordance with IAS 34 are based on the assumption that users of the interim financial reports will also have access to the most recent annual financial statements, which is why IAS 34 requires minimum disclosures. However, IAS 34 also requires an entity to disclose any events or transactions that are material to an understanding of the current interim period. If a first-time adopter did not disclose, in its most recent annual financial statements prepared in accordance with previous GAAP, information material to an understanding of the current interim period, then it should disclose that information in its interim financial report or include a cross-reference to another published document that includes the information.

Chapter 2

The Conceptual Framework and Financial Statement Presentation

Overview

2.01 The objective of this chapter is to explain the concepts underlying the preparation and presentation of financial statements to assist

- preparers of financial statements in the application of International Financial Reporting Standards (IFRSs) and topics yet to be addressed in IFRSs.
- auditors when forming an opinion on whether financial statements comply with IFRSs.
- external users of financial statements in the interpretation of the information contained in financial statements prepared in accordance with IFRSs.

2.02 The chapter is organized in two sections. The first section describes the International Accounting Standards Board's (IASB's) *Conceptual Framework for Financial Reporting* (conceptual framework) and explains the concepts that underlie financial reporting for external users. The second section describes the basis for the presentation of general purpose financial statements to ensure comparability across the entity's financial statements over time and with the financial statements of other entities. It sets out the guidelines for the structure and content of financial statements.

Summary of Selected Accounting Guidance

2.03 The primary accounting literature relating to the underlying concepts used in the preparation and presentation of financial statements for external users is the conceptual framework, which:

- is not an IFRS.
- does not define standards for any particular measurement or disclosure issue.
- cannot override any specific IFRS.

2.04 When the conceptual framework is in conflict with an IFRS, the requirements of the IFRS should prevail.

2.05 International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, is the primary guidance an entity should apply in the preparation and presentation of general purpose financial statements in accordance with IFRSs.

Scope and Scope Exceptions

2.06 The scope of the conceptual framework and the conceptual framework section of this chapter applies to all entities and covers the following:

- The objective of financial reporting
- The qualitative characteristics of useful financial information
- The definition, recognition, and measurement of the elements from which financial statements are constructed
- Concepts of capital and capital maintenance

2.07 IAS 1 and the guidance in the "Presentation of Financial Statements" section of this chapter also apply to all entities when preparing and presenting general purpose financial statements in accordance with IFRSs. The scope of IAS 1 includes the following:

- Entities that present consolidated financial statements in accordance with IFRS 10, *Consolidated Financial Statements*, and those that present separate financial statements in accordance with IAS 27, *Separate Financial Statements*
- Profit-oriented entities including those in the public sector

2.08 IAS 1 uses terminology suitable to for-profit entities. Public and private sector entities with not-for-profit activities could choose to apply IAS 1, but they may need to amend descriptions used in IAS 1 for particular line items in their financial statements and for the financial statements themselves.

2.09 Additionally, entities with members' or unit holders' interest that do not meet the definition of equity in IAS 32, *Financial Instruments: Presentation*, may need to adapt their presentation of these interests. This may be the case for some mutual funds and other entities, such as cooperatives, with share capital that is not considered equity.

2.10 IAS 1 does not address recognition, measurement, and disclosure requirements for specific transactions and other events. These requirements are within the scope of other IFRSs.

2.11 Generally, IAS 1 does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34, *Interim Financial Reporting*. However, an entity preparing condensed financial statements in accordance with IAS 34 should meet the requirements of paragraphs 15–35 in IAS 1. Refer to IAS 1 and paragraphs 2.14–.24 in this chapter for guidance on these requirements.

Conceptual Framework for Financial Reporting

2.12 The first section of this chapter describes the objective of general purpose financial statements, the qualitative characteristics of and constraint on useful financial information, the elements of the financial statements and their recognition and measurement, and the concepts of capital and capital maintenance that underpin accounting models that an entity may select in preparing its financial statements.

Objective of General Purpose Financial Reporting

2.13 The objective of general purpose financial reporting is to provide useful information to existing and potential investors, lenders, and other creditors that will assist them in making investment and credit decisions about a reporting entity. Investment and credit decisions include buying, holding, or selling an entity's debt and equity instrument and depend on the expected returns from these instruments. Returns include dividends, principal and interest payments, or increases in market prices. In turn, investors' and creditors' expectations about returns depend upon the amount, timing, and uncertainty of future net cash inflows to the entity. Therefore, it is essential that financial reporting provide information that permits assessment of the prospect for future net cash inflows to an entity. Assessing an entity's future net cash flows requires access to information about an entity's resources and claims against them, the efficiency and effectiveness of the entity's management, and how its governing board discharges its responsibilities. So, the bottom line of general purpose financial statements is to provide useful information to investors, creditors, and other users of those statements that will assist them in assessing the amount, timing, and uncertainty (risk) of an entity's expected future cash flows so that they can include that assessment in their investment and credit decisions.

Qualitative Characteristics of Useful Information

2.14 When determining the information that an entity should include in its financial statements, it is important to understand the types of information that existing and potential investors and creditors would find most useful for their decision-making. Therefore, the conceptual framework defines the following fundamental and secondary qualitative characteristics of useful information. These characteristics apply not only to the financial information provided in the financial statements, but also to financial information an entity might provide elsewhere.

- *Relevance.* Information that is capable of making a difference in user's decisions, even if some users choose not to take advantage of that information or are already aware of it. Such information has predictive value, feedback value, or both.
  - *Materiality.* Information that, if omitting or misstating it, could influence users based on the basis of financial information about a specific entity; that is, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in an individual entity's financial report.
- *Faithful representation.* Financial information must not only represent relevant information, but must also faithfully represent the phenomena that it purports to represent. Representational faithfulness is a necessary, but not sufficient condition, for financial information to be useful. To have this characteristic, the financial information must be the following:
  - *Complete* means the representation includes all information necessary for a user to understand the phenomena it represents.
  - *Neutral* means the representation is without bias in the selection and presentation of the financial information.
  - *Free from error* means there are no errors or omissions in the description of the phenomenon, and there are no errors in the process selected, applied, and used to produce the reported information. This does not mean that the information is accurate in all respects. An estimate of an unobservable price or value cannot be characterized as accurate or inaccurate.

2.15 The conceptual framework also describes the following qualitative characteristics as enhancing characteristics of information that an entity already determines to be relevant and representationally faithful:

- *Comparability* enables users to identify and understand similarities in, and differences among, items. *Consistency,* the use of the same methods for the same items, either over time for a single entity or over entities for a single period, is not the same as comparability. However, consistency helps an entity achieve comparability.
- *Verifiability* means that different knowledgeable and independent observers could reach consensus, although not necessarily a complete agreement, that a particular representation is a faithful representation.
- *Timeliness* means having information available to decisionmakers in time to be capable of influencing their decisions.
- *Understandability* means classifying, characterizing, and presenting information clearly and concisely, including information about inherently complex phenomena. Excluding such phenomena because an entity finds it is difficult to understand would leave the financial reports incomplete and potentially misleading.

2.16 In addition to defining the necessary qualitative characteristics of financial reporting, the conceptual framework recognizes that preparing financial statements that perfectly meet these characteristics is costly. Therefore, the conceptual framework describes a pervasive cost constraint and states that it is important that those costs are justified by the benefits of reporting the information.

2.17 Refer to chapter 3 of the conceptual framework for additional guidance about applying the qualitative characteristics of financial information.

Underlying Assumption

2.18 The financial statements are normally prepared with the assumption that the entity is a going concern and will continue in operation for the foreseeable future. If the entity intends to liquidate or materially curtail the scale of its operations, the entity may have to prepare its financial statements on a different basis and should disclose the basis used.

Elements of Financial Statements

2.19 Financial statements portray the financial effects of transactions and other events from grouping them in broad classes, called "elements" of the financial statements, according to their economic characteristics. An entity presents these elements in the statement of financial position and the statement of profit or loss and other comprehensive income.

2.20 The elements directly related to the measurement of financial position are

- *asset*, which is defined as a resource controlled by the entity as a result of past events and from which the entity expects future economic benefits to flow.
- *liability*, which is defined as present obligation of the entity as a result of past events, the settlement of which the entity expects to result in an outflow of resources underlying economic benefits.
- *equity*, which is defined as the residual interest in the entity's assets after deducting its liabilities.

2.21 The elements that relate to performance presented on the statement of income are

- *income*, which is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from equity participants. Income includes
  - *revenues*, which are income items that arise in the course of the entity's ordinary activities; and
  - *gains*, which also represent increases in economic benefits, may or may not arise in the course of the entity's ordinary activities, and, as such, are not different in nature from revenues. However, gains are not considered a separate element.
- *expenses*, which are decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity participants. Expenses include
  - *losses*, which also represent decreases in economic benefits. Losses may or may not arise in the course of the entity's ordinary activities and, as such, are not different in nature from revenues. However, losses are not considered a separate element.
- *capital maintenance adjustments*, which are revaluations or restatements of assets and liabilities that give rise to increases or decreases in equity. These adjustments may or may not be included in the statement of income depending upon the concept of capital employed. An entity recognizes some capital maintenance adjustments directly in equity. Refer to paragraph 2.24 for a discussion of two concepts of capital maintenance.

Refer to paragraphs 4.2–.36 in chapter 4, "The Conceptual Framework for Financial Reporting," of the conceptual framework for additional guidance on the definitions of financial statement elements.

Recognition of the Elements of Financial Statements

2.22 Recognition is the process of incorporating items that meet the definitions of assets, liabilities, and equity in the statement of financial position, and items that meet the definitions of income, revenues, and expenses in the statement of profit or loss and other comprehensive income. An entity recognizes an element that meets the definition of an element if it also meets both of the following criteria:

- *Probability criteria*. It is probable (that is, more likely than not) that any future economic benefits associated with the item will for to or from the entity.
- *Measurement reliability criteria*. The entity can measure the cost or value of the item reliability.

Refer to paragraphs 4.37–.53 in chapter 4 of the conceptual framework for additional guidance on applying the recognition criteria to the different financial statement elements.

Measurement of the Elements of Financial Statements

2.23 *Measurement* is the process of determining the monetary amounts at which the entity recognizes financial statement elements and carries them on the statements of financial position and comprehensive income. This process requires the entity to select a measurement basis. The conceptual framework identifies the following measurement bases that entities have used in financial statements:

- Historical use (most commonly adopted measurement basis)
  - *Assets*. The amount of cash or cash equivalents paid, or the fair value of consideration given to acquire an asset at the time of acquisition.
  - *Liabilities*. The amount of the proceeds received in exchange for the obligation or, in some circumstances, the amount of cash or cash equivalents the entity expects to pay to satisfy the liability in the normal course of business.
- Current cost
  - *Assets*. The amount of cash or cash equivalents that the entity would have to pay if the same or equivalent asset was acquired currently.
  - *Liabilities*. The undiscounted amount of cash or cash equivalents the entity would pay to settle the liability currently.
- Realizable (settlement) value
  - *Assets*. The amount of cash or cash equivalents that the entity could currently obtain by selling the asset in an orderly disposal.
  - *Liabilities*. The *settlement value*; that is, the undiscounted amount of cash or cash equivalents that the entity expects to pay to satisfy the liability in the normal course of business.
- Present value
  - *Assets*. The discounted value of the future net cash inflows that the entity expects the item to generate in the normal course of business.
  - *Liabilities*. The discounted value of the future net cash outflows that the entity expects to pay to settle the liability in the normal course of business.

Refer to paragraphs 4.54–.56 of chapter 4 of the conceptual framework for additional discussion of these measurement bases.

Concepts of Capital and Capital Maintenance

2.24 The conceptual framework defines two concepts of capital maintenance:

- Financial concept of capital and capital maintenance
  - *Concept of capital*. Net assets or equity of the entity.
  - *Definition of* profit. The entity earns a profit only if the financial (or money) amount of the net assets increases over the accounting period, after excluding any contributions from or distributions to equity participants. Financial capital maintenance is measured either in nominal monetary units or units or constant purchasing power, but the entity is not required to adopt a particular measurement basis in its financial statements.
  - *Treatment of unrealized gains and losses from price changes*. Such changes are conceptually profit and the entity should recognize these changes in profit or loss in the accounting period.
- Physical capital maintenance
  - *Concept of capital*. Productive capacity of the entity (for example, based on units per day).
  - *Definition of* profit. The entity earns a profit only if its physical productive capacity (or operating capability) or the resources of funds needed to achieve that capacity increases over the accounting period, excluding any contributions from or distributions to equity participants. Physical capital maintenance requires the entity to adopt the current cost measurement basis in its financial statements.
  - *Treatment of unrealized gains and losses from price changes*. All price changes affecting the entity's assets and liabilities are viewed as changes in the measurement of the entity's physical productive capacity and the entity treats these changes as capital maintenance adjustments to equity and not as profit.

2.25 Given these two concepts of capital and their disparate effects on the financial statements and performance (profit), an entity should select a concept based on the needs of the users of its financial statements. An entity would adopt the financial concept of capital if the users of its statements are primarily concerned with the maintenance of nominal invested capital or purchasing power of capital. An entity would adopt the physical concept of capital if the main concern of users is the entity's productive capacity or capability. The entity's selection of a concept of capital determines the accounting model used in the preparation and presentation of its financial statements.

2.26 The conceptual framework states that the IASB does not currently intend to prescribe a particular accounting model other than in exceptional circumstances, such as, in the model required when an entity reports in a currency of a hyperinflationary economy. However, different accounting models exhibit different degrees of relevance and reliability; entities should see a balance between these two qualitative characteristics.

2.27 Refer to paragraphs 4.57–.65 of chapter 4 of the conceptual framework for additional discussion of these concepts of capital.

Presentation of Financial Statements

2.28 The second section of this chapter describes the basis for the presentation of general purpose financial statements, setting out guidelines for their structure, and the minimum requirements for their content, while applying the concepts, purpose, characteristics, definitions of the elements of the financial statements, recognition criteria, measurement bases, and concepts of capital and capital maintenance described in the "Conceptual Framework for Financial Reporting" section of this chapter.

The Purpose and Contents of Financial Statements

2.29 An entity represents its financial position, performance, and cash flows through the structure of its financial statements. The information in an entity's financial statements communicates the results of management's stewardship of the entity's entrusted resources. To meet the objective of financial statements to provide useful information that permits users to assess the amount, timing, and uncertainty of the entity's future cash flows, an entity should provide the following information:

- Assets
- Liabilities
- Equity
- Income and expenses, including gains and losses
- Contributions by and distributions to owners in their capacity as owners
- Cash flows
- Note disclosures

2.30 A complete set of financial statements comprises the following:

- Statement of financial position as of the end of the period
- Statement of profit or loss and other comprehensive income for the period
- Statement of changes in equity for the period
- Statement of cash flows for the period
- Notes to the financial statements that include a summary of significant accounting policies and other explanatory information
- Comparative information in respect to the preceding period for all amounts reported in the current period's financial statements
- Statement of financial position as of the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements

2.31 IAS 1 permits an entity to use statement titles other than the titles described in paragraph 2.30 of this chapter. However, the entity should present each and all statements with equal prominence in the complete set of financial statements.

2.32 In accordance with paragraph 10A of IAS 1, the entity can present the components of profit or loss either as

a. part of a single statement of profit or loss and other comprehensive income, or

b. in a separate income statement, which must be presented immediately before the statement presenting comprehensive income in the complete set of financial statements.

2.33 In addition to the financial statements, management may also present a financial review (management discussion and analysis) outside the financial statements, which describes the main features of the entity's financial performance, financial position, and the principal uncertainties the entity may face. An entity's financial review may include the following:

- Main factors and influences that determined the entity's financial performance including:
  - Changes in the environment in which it operates
  - How it responded to those changes
  - The effect those changes had on the entity's policy for investment to maintain and enhance financial performance, including its dividend policy
- Funding sources and its targeted ratio of liabilities to equity
- Resources not recognized in the statement of financial position in accordance with IFRSs

2.34 Additionally, an entity may present other valued-added statements outside the financial statements, such as environmental reports. When an entity provides reports and statements outside its financial statements, the content and structure of these reports are outside the scope of IFRSs.

Fair Presentation and Compliance With IFRSs

2.35 An entity is required to present fairly its financial position, financial performance, and cash flows. Fair presentation requires the entity to prepare financial statements that faithfully represent the effects of transactions, and other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income, and expenses set out in the conceptual framework. In virtually all circumstances, when an entity applies all of the requirements of IFRSs, it achieves a fair presentation.

2.36 When an entity's financial statements comply with IFRSs, IAS 1 requires the entity to make an explicit and unreserved statement of such compliance in the notes to its financial statements. An entity's financial statements are only in compliance with IFRSs when they meet the requirements of all IFRSs. Fair presentation also requires an entity to

- select and apply accounting policies in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 sets out a hierarchy of authoritative guidance for management to consider when no other IFRS applies to an item.
- present its information, including its accounting policies, in a manner that provides relevant, reliable, comparable, and understandable information.
- provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the effect of particular transactions, other events, and conditions on the entity's financial position and financial performance.

2.37 IAS 1 warns that an entity cannot rectify inappropriate accounting policies either by disclosure of the policies used or by notes or other explanatory material.

2.38 In an extremely rare circumstance, an entity may conclude that complying with the requirements of a particular IFRS would be so misleading that the entity would not meet the objective of financial statements described in the conceptual framework. If this should occur, the entity should depart from that requirement only if its relevant regulatory conceptual framework requires or otherwise does not prohibit such a departure. When an entity departs from the requirement of IFRSs, it should disclose the following:

a. The fact that management concludes that the financial statements present fairly the entity's financial position, performance, and cash flows

b. That the entity complied with applicable IFRSs, but that, in order to achieve a fair presentation, it departed from a particular requirement

c. The title of the IFRS from which the entity departed and the following information about the departure:

   i. Nature of the departure

   ii. Treatment that the IFRSs would have required

   iii. Reason why applying the required treatment would be so misleading that it would conflict with the objective of financial reporting in the conceptual framework

   iv. Treatment adopted

d. For each period presented, the financial effect of the departure on each item in the financial statements that would have been reported if the entity complied with the requirement

2.39 When the departure occurred in a prior period, but affects the amounts recognized in the current period, the entity also should disclose the information in paragraph 2.38*c–d*. For example, a departure from an IFRS in a prior year might affect the carrying value of depreciable assets. Therefore, the entity would make the necessary disclosures because the carrying value of these assets and the amount of depreciation in the current period's financial statements are affected.

2.40 In the extremely rare circumstance that management concludes that compliance with an IFRS requirement would be so misleading that it would conflict with the financial statement objectives described in the conceptual framework, the entity's relevant regulatory framework prohibits a departure from IFRSs. Then, the entity should reduce the perceived misleading aspects of compliance with the IFRS requirement, by disclosing the following information:

- Title of the IFRS in question, the nature of the requirement, and the reason management concluded that complying with the requirement would be so misleading that it would conflict with the objective of financial statements set out in the conceptual framework
- For each period presented, the adjustments to each item in the financial statements that are necessary to achieve a fair presentation

Going Concern

2.41 Paragraph 4.1 of the conceptual framework and paragraph 2.18 of this chapter discuss the concept of a going concern with respect to preparing financial statements. IAS 1 requires an entity's management to

- make an assessment about its ability to continue as a going concern when preparing its financial statements.
- prepare financial statements on a going concern basis unless management intends to, or does not have realistic alternatives to, liquidate the entity or cease trading.

2.42 When making the going concern assessment, if the entity is aware of material uncertainties related to events or conditions that may cast significant doubt about its ability to continue as a going concern, the entity should disclose these uncertainties.

2.43 If an entity does not prepare its financial statements on a going concern basis, it should disclose the following:

- The fact that the financial statements were not prepared on a going concern basis
- The basis on which the financial statements were prepared (for example, liquidation basis)
- The reason management does not regard the entity to be a going concern

2.44 When making a going concern assessment, management should take into account all available information about the entity's future at least, but not limited to, 12 months from the end of the reporting period. The amount of detail included in an analysis performed by management depends upon the facts in a particular case.

Accrual Basis of Accounting

2.45 Except for cash flow information, the entity should use the accrual basis of accounting when preparing its financial statements. As described in the conceptual framework, an entity should recognize all elements of the financial statements—assets, liabilities, equity, income, and expenses—using the accrual basis when the recognition criteria for each element are satisfied.

Materiality and Aggregation

2.46 An entity should present separately each material class of similar items in its financial statements. An entity should also present items separately when they are dissimilar in nature or function, provided they are not immaterial.

Offsetting

2.47 Unless permitted or required by an IFRS, an entity should not offset assets and liabilities or income and expenses.

2.48 An entity should report assets, liabilities, income, and expenses separately in its financial statements. Offsetting these elements detracts from a user's ability to assess an entity's future cash flows and to understand the transactions, as well as other events and conditions that have occurred. An entity should not offset elements in the financial statements unless a net presentation reflects the substance of the transaction or other event. However, IFRSs do not consider measuring assets net of valuation allowances offsetting. Examples of presentation of assets net of valuation allowances include inventory net of allowance for obsolete inventory or accounts receivable net of an allowance for estimated uncollectibles.

2.49 In contrast, IAS 18, *Revenue*, requires an entity to measure revenue at the fair value of the consideration received or receivable net of any trade discounts or volume rebates taken. During the ordinary course of activities, an entity may have some incidental transactions that do not generate revenue. IAS 1 permits the entity to net any income on these incidental transactions with the related expenses when a net presentation reflects the substance of the transaction. For example, an entity determines the gain or loss on the sale of property, plant, and equipment (PP&E) by netting the carrying value of the asset against the proceeds received from the sale. In addition, an entity may present gains and losses from similar transactions on a net basis, unless the gains or losses are material. For example, an entity could present foreign exchange gains and losses net, except that the entity should present an individually material gain or loss separately.

Frequency of Reporting

2.50 An entity should present a complete set of financial statements, including comparative information, at least annually. However, IAS 1 does not preclude an entity from reporting for a 52-week period rather than a year.

2.51 When an entity changes the end of its reporting period, it may present its financial statements for a period longer or shorter than one year. In this case, an entity should disclose the following information:

- The length of the period covered
- The reason for using a longer or shorter period
- The fact that the amounts presented for different periods in the entity's financial statements are not entirely comparable

Comparative Information

2.52 Comparability enhances the usefulness of relevant and representationally faithful information. Therefore, IAS 1 requires an entity to present comparative information for the preceding period for all amounts reported in the entity's current period financial statements, unless omission of comparative information is permitted or required by IFRSs. An entity should also provide comparative narrative and descriptive information when relevant for an understanding of the current period financial statements.

2.53 To achieve comparability, an entity should, at a minimum, present the following:

a. Two statements of financial position

b. Two statements of profit or loss and other comprehensive income (or two separate statements of profit or loss, if presented)

c. Two statements of changes in equity

d. Two statements of cash flows

e. Related notes

2.54 When an entity applies an accounting policy retrospectively, reclassifies items, or makes a retrospective restatement of items in its financial statements, it should, at a minimum, present the following:

- Three statements of financial position
  - As of the end of the current period
  - As of the end of the previous period, which is the same as the beginning of the current period
  - As of the beginning of the earliest comparative period
- Two each of the other statements, as described in 2.53*b–d*
- Related notes

2.55 In some cases, narrative information from a previous period may remain relevant to an entity's current period. For example, details of a legal dispute with an uncertain outcome disclosed in the preceding reporting period may still be relevant in the current year. Therefore, the entity should disclose the details of the unresolved legal dispute in the current period financial statements, which include any changes in status and the steps management has taken during the period to resolve it.

2.56 When an entity changes the presentation or classification of items in its financial statements, it should reclassify comparative amounts, unless it is impracticable to do so. When it reclassifies comparative amounts, an entity should disclose all of the following:

- Nature of the reclassification
- Amount of each reclassified item or class of items
- Reason for the reclassification

2.57 When it is impracticable to reclassify comparative amounts, the entity should disclose the following:

- Reasons for not reclassifying the amounts
- Nature and amount of the adjustments the entity would have made if the amounts had been reclassified

2.58 Reclassification of financial statement information to achieve comparability assists users in assessing trends in financial information for predictive purposes. However, in some circumstances, the entity may find it impracticable to achieve comparability by reclassifying comparative information for a particular period. This may occur, for example, when the entity cannot retrieve the necessary data from prior periods in such a way that would allow the reclassification, and recreation or collection of the information may not be possible.

2.59 IAS 8 requires certain adjustments to comparative information when an entity changes an accounting policy or corrects an error. Refer to IAS 8 and chapter 30, "Accounting Policies, Changes in Accounting Estimates, and Errors," of this book for additional guidance on this issue.

Consistency of Presentation

2.60 To achieve consistency of presentation, an entity should retain the presentation and classification of financial statements items from period to period, unless

- it is apparent to the entity, after a significant change in the nature of an entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate taking into account the criteria in IAS 8 for selection and application of accounting policies; or
- an IFRS requires a change in presentation.

2.61 When an entity changes the presentation of its financial statements, it should remember that such a change affects its ability to achieve both consistency and comparability. Therefore, an entity should only change the presentation in the following circumstances:

- The new structure provides information that is reliable and more relevant to financial statement users.
- The revised structure is likely to continue, so that it does not impair its comparability in future periods.

Identification of the Financial Statements

2.62 An entity should clearly identify its financial statements and distinguish them from other information presented in the same published document because IFRSs only apply to an entity's financial statements and not necessarily to other information appearing in the same document, whether it is an annual report, regulatory filing, or other report.

2.63 The entity should clearly identify each financial statement and note disclosure, presenting information in a way that is understandable, as well as repeating the information when necessary. In accordance with paragraph 51 of IAS 1, the entity should prominently display the following information:

- Name of the reporting entity or other means of identification, including any change in that information from the end of the preceding reporting period
- Whether the financial statements are of an individual entity or a group of entities
- The date of the end of the reporting period or the period covered by the set of financial statements or notes
- The presentation currency, as defined in IAS 21, *The Effects of Changes in Foreign Exchange Rates*
- The level of rounding used in presenting amounts in the financial statements (for example, thousands or millions of currency units)

2.64 An entity should use judgment in determining the best way to present its financial information, including the appropriate presentation of page headings, statements, notes, columns, and so forth. For example, an entity sometimes provides financial statements electronically, which does not require separate pages. Therefore, the entity is responsible for presenting the financial statements in a way that ensures that it provides the information in a way so that users can access and understand it.

Statement of Financial Position

2.65 An entity includes, at a minimum, the following line items in a statement of financial position:

- Assets
  - Cash and cash equivalents
  - Trade and other receivables
  - Inventories
  - PP&E
  - Intangible assets
  - Biological assets
  - Investment property
  - Financial assets, excluding investments accounted for using the equity method, trade and other receivables, and cash and cash equivalents, all of which are separately presented
  - Investments accounted for using the equity method
  - The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*
- Liabilities
  - Trade and other payables
  - Provisions
  - Financial liabilities, trade and other payables and provisions, both of which are separately presented
  - Liabilities and assets for current tax, as defined in IAS 12, *Income Taxes*
  - Deferred tax liabilities and deferred tax assets, as defined in IAS 12
  - Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5
- Equity
  - Noncontrolling interests presented within equity
  - Issued capital and reserves attributable to owners of the parent

When it is relevant to the understanding of its financial position, an entity should present additional line items, headings, and subtotals in this statement.

Current and Noncurrent Distinction

2.66 IAS 1 requires an entity to present current and noncurrent assets and current and noncurrent liabilities as separate classifications in the statement of financial position unless a liquidity order presentation is reliable and more relevant to the users of the financial statements. A liquidity order presentation may be more relevant for insurance and other financial institutions. Whichever presentation the entity adopts, it should disclose the amount it expects to recover or settle after more than 12 months for each asset and liability line item that combines amounts that the entity expects to recover or settle 12 months or less, and more than 12 months after the reporting period.

2.67 IAS 1 does not require a particular order or format beyond the described requirement for a classified or liquidity order statement of financial position. Therefore, an entity is free to structure the statement in increasing or decreasing liquidity within the asset and liability sections. Some entities should structure the statement in this way to show current assets followed by current liabilities, which facilitates presentation of a calculation of working capital.

2.68 As mentioned previously in this chapter, an entity should separately present items that are sufficiently different in nature or function. In order to provide information that is relevant to an understanding of its financial position, an entity should also

- present additional line items, beyond the minimum required, when the size, nature, or function of an item or aggregation of similar items.
- amend the descriptions used and the ordering of items or aggregation of similar items according to the nature of the entity and its transactions.

2.69 The separate presentation of additional items is based on an entity's judgment and its assessment of the following:

- Nature and liquidity of the entity's assets
- Function of assets within the entity
- Amounts, nature, and timing of the entity's liabilities

2.70 An entity may present different classes of assets as separate line items based on their measurement basis. When an entity uses different measurement bases, it suggests that the assets measured differently vary by nature, function, or both. An example is an entity measuring at cost its land and buildings used in operations and classified as PP&E in accordance with IAS 16, *Property, Plant and Equipment*, but measuring at fair value its land and buildings held for rent or capital appreciation and classified as investment property in accordance with IAS 40, *Investment Property*.

2.71 Even when the entity presents a statement of financial position with current and noncurrent classifications, IAS 1 permits presentation of some assets and liabilities in liquidity order when that presentation is reliable and more relevant. This blending of presentations may occur when an entity's operations are diverse.

2.72 When assessing an entity's liquidity and solvency, users of the financial statements find that information about the dates the entity expects to recover assets and settle liabilities is useful, whether the assets or liabilities in question are classified as current or noncurrent. IFRS 7, *Financial Instruments: Disclosures*, requires disclosure of the maturity dates of financial assets, which include trade and other receivables, and financial liabilities, including trade and other payables.

Current Assets

2.73 An asset is classified as current when it meets one or more of the following criteria:

- The entity expects to realize, sell, or consume the asset within the entity's normal operating cycle.
- The entity holds the asset primarily for the purpose of trading (that is, short-term gains and losses).
- The entity expects to realize the asset within 12 months after the entity's reporting period.
- The asset is cash or a cash equivalent, as defined in IAS 7, *Statement of Cash Flows*, unless the entity is restricted from exchanging or using the asset to settle a liability for at least 12 months after the entity's reporting period.

2.74 An entity classifies as noncurrent all assets that do not meet the criteria for classification as current.

2.75 An *operating cycle* is the time between the entity's acquisition of an asset for use or processing and when it realizes cash or cash equivalents from its sale or disposition. IAS 1 assumes an entity's normal operating cycle is 12 months if its operating cycle is not clearly identifiable. Current assets are those that are sold, consumed, or realized as part of the entity's normal operating cycle, such as trade receivables and inventories, even if the entity does not expect to realize them within 12 months after the reporting period. Current assets include the current portion of noncurrent financial assets and assets held for the purpose of trading, including those meeting the definition of held for trading in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*.

2.76 An entity should not classify deferred tax assets and liabilities as current assets and current liabilities in a statement of financial position that distinguishes current and noncurrent assets and liabilities.

2.77 Noncurrent assets include both tangible and intangible assets, as well as financial assets that are of a long-term nature. An entity may identify noncurrent assets using alternative descriptions, as long as those descriptions are clear and not misleading.

Current Liabilities

2.78 A liability is classified as current when one or more of the following criteria are met:

- The entity expects to settle the liability in the entity's normal operating cycle.
- The entity holds the liability primarily for the purpose of trading.
- The entity expects to settle the liability within 12 months after the reporting period.
- The entity does not have an unconditional right to defer settlement for at least 12 months after the reporting period.

2.79 A liability's classification as current or noncurrent is not affected when, under the terms of the contract and at the option of the counterparty, the entity could settle the liability by an issue of equity instruments.

2.80 An entity classifies as noncurrent all liabilities that do not meet the criteria for classification as current.

2.81 Some current liabilities are part of working capital used in an entity's normal operating cycle, such as trade payables, other operating costs, and some accruals for employees. Even if these liabilities are due to settle more than 12 months after the end of the reporting period, the entity classifies these working capital items as current liabilities.

2.82 Current liabilities include the current portion of noncurrent financial liabilities, some financial liabilities that meet the definition of held for trading in IAS 39, bank overdrafts, and dividends payable, income taxes, and other nontrade payables. However, financial liabilities are noncurrent liabilities when they provide financing on a long-term basis and are not due to settle within 12 months after the end of the reporting period. These financial liabilities are not part of the entity's working capital used in its normal operating cycle.

2.83 However, an entity classifies a financial liability as current when it is due to settle within 12 months after the end of the reporting period even if

- its original term was for a period longer than 12 months, and
- the entity completes an agreement to refinance, or to reschedule payments, on a long-term basis after the end of the reporting period and before the financial statements are authorized for issue.

2.84 When an entity has both the discretion and expectation to refinance or roll over an obligation for at least 12 months after the end of the reporting period under an existing loan agreement, the entity classifies the obligation as noncurrent, even when the obligation would otherwise be due within a shorter period. However, if it does not have unconditional discretion to refinance or rollover the liability before the end of the reporting period, the entity should classify the obligation as current. The entity does not take a potential refinancing of the obligation into account when determining the current or noncurrent classification.

2.85 When the entity breaches a provision of a long-term loan agreement on or before the end of the reporting period, with the effect that the liability becomes payable on demand, the entity should classify the liability as current, regardless of whether the lender agrees not to demand payment after the end of the reporting period and before the financial statements are authorized for issue. Similar to the case in the preceding paragraph, when an entity does not have an unconditional right to defer settlement of a liability for at least 12 months after the end of its reporting period, it should classify the liability as current. However, when the lender agrees not to demand payment of the liability for at least 12 months after the end of the reporting period to allow the entity time to rectify the breach, the entity should continue to classify the liability as noncurrent.

2.86 IAS 10, *Events After the Reporting Period*, requires an entity to disclose the following nonadjusting events related to loans classified as current liabilities that occur between the end of the reporting period and the date the financial statements are authorized for issue:

- The entity's refinancing of the loan on a long-term basis
- The entity's rectifying a breach of a long-term loan arrangement
- The lender's grant of a grace period of at least 12 months after the end of the reporting period to allow the entity to rectify a breach of a long-term loan arrangement

Information Presented in Either the Statement or the Notes

2.87 An entity should disclose, in a manner appropriate to its operations, additional subclassifications of line items presented in either the statement of financial position or the notes. The detail the entity provides depends on the size, nature, and function of the amounts, as well as any specific requirements of IFRSs. When determining a subclassification of line items, an entity should use its judgment in assessing the nature and liquidity of their assets and their function, along with the amounts, nature, and timing of their liabilities. The disclosures can vary for each item. For example, an entity disaggregates PP&E into asset classes in accordance with IAS 16; provisions are disaggregated into provisions for employee benefits and other items; and equity capital and reserves are disaggregated into various classes, such as share capital, additional paid-in capital, and accumulated other comprehensive income accounts.

2.88 With respect to equity, for each class of share capital, an entity discloses the following information in either the statement of financial position, the statement of changes in equity, or the notes:

- Number of shares authorized
- Number of shares issued that are fully and partially paid
- Per share par value or that the shares have no par value
- Reconciliation of the number of shares outstanding at the beginning and at the end of the period
- Rights, preferences, and restrictions attached to that class, which may include restrictions on the distribution of dividends and the repayment of capital
- Shares in the entity that are held by the entity or held by the entity's subsidiaries or associates
- Shares that the entity has reserved for issue under options and contracts for the sale of shares, including the disclosure of their terms and amounts

2.89 An entity, such as a partnership or trust, may not have share capital. In this case, the entity discloses information equivalent to that required by entities with share capital listed in the previous paragraph, showing changes during the period in each category of equity interests, and the rights, preferences, and restrictions attached to each category.

2.90 IAS 1 requires an entity that reclassifies the following financial instruments between liabilities and equity to disclose the amount reclassified into and out of each category and the timing and reason for reclassification:

- A puttable financial instrument classified as equity
- An instrument classified as equity that imposes on the entity an obligation to deliver to another party a pro rata share of the entity's net assets only on liquidation

Statement of Profit or Loss and Other Comprehensive Income[1]

2.91 The statement of profit or loss and other comprehensive income (formerly, statement of comprehensive income) should present the following information:

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[1] In June 2011, the International Accounting Standards Board issued *Presentation of Items of Other Comprehensive Income, Amendments to IAS 1*. Among other changes, this amendment changed the title of this performance statement from *Statement of Comprehensive Income* to *Statement of Profit or Loss and Other Comprehensive Income*. This chapter incorporates the guidance for all of the amendments to International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, included in this document.

a. Profit or loss section, which should include line items that present the following amounts:

   i. Revenue

   ii. Finance (interest) costs

   iii. Share of profit or loss of associates and joint ventures accounted for using the equity method

   iv. Tax expense

   v. A single amount for the total of discontinued operations in accordance with IFRS 5

b. Other comprehensive income section, which should do the following:

   i. Present the following line items:

      (1) Amounts of other comprehensive income in the period, classified by nature

      (2) Share of other comprehensive income of associates and joint ventures using the equity method

   ii. Group the previous line item into those that, in accordance with other IFRSs, the entity will do the following:

      (1) Not subsequently reclassify to profit or loss

      (2) Subsequently reclassify to profit or loss when specific conditions are met

c. Present, in addition to the profit or loss and other comprehensive income sections, the following:

   i. Profit or loss

   ii. Total other comprehensive income

   iii. Comprehensive income for the period (that is, the total of profit or loss and other comprehensive income)

2.92 An entity may present the profit or loss and other comprehensive income sections of this statement either as one statement or two separate statements. If the entity chooses to present the statement of profit or loss and other comprehensive income as separate statements, it should

- present all of the line items described in paragraph 2.91*a*(i)–(v) in the profit or loss statement.
- present the statement of profit or loss and other comprehensive income immediately following the statement of profit or loss.
- not present
  — items of the other comprehensive income section in the profit or loss statement.
  — items of the profit or loss section in the statement presenting comprehensive income.

2.93 An entity should not present any items of income or expense as extraordinary items in the notes or statement of profit or loss and other comprehensive income when it uses a one or two statement format.

2.94 An entity should also present allocations of profit or loss for the period and total comprehensive income for the period attributable to

a. noncontrolling interests, and

b. owners of the parent entity.

2.95 When it is relevant to an understanding of its financial performance, the entity should present additional line items, headings, and subtotals in the statement of profit or loss and other comprehensive income, whether it uses a one or two statement format. Disclosing the components of an entity's financial performance assists users in understanding the financial performance the entity has already achieved. This, in turn, improves users' ability to forecast the entity's future financial performance because various activities, transactions, and other events differ in frequency and the potential for gain or loss and predictability.

Profit or Loss for the Period

2.96 An entity should recognize in profit or loss all items of income and expense in a period another IFRS requires or permits otherwise. For example, IAS 8 requires retrospective application of an error correction and a change in accounting policy. Additionally, some IFRSs permit or require an entity to recognize some income and expense items in other comprehensive income; such changes in fair value for financial assets are classified as available for sale.

2.97 An entity should also present the expenses recognized in profit or loss classified either by their nature or their function within the entity, whichever classification is reliable and more relevant. This classification is often referred to as an analysis of expenses and has two formats: nature of expense or function of expense.

2.98 When an entity presents its expenses using the nature of expense format, an entity categorizes its expenses only by their nature. For example, the entity includes all depreciation expense in a single line item and does not disaggregate it into depreciation expense on productive assets and into depreciable assets used in administrative activities. When an entity elects this formation, it does not also allocate expense to functions, such as production, marketing, and administration. The following is an example of the nature of expense method of classification as presented on an income statement.

Revenue	X
Other income	X
Total income	X
Expenses	
Changes in inventories of finished goods and work in progress	X
Raw materials and consumables used	X
Employee benefits expense	X
Depreciation and amortization expense	X
Finance costs	X
Other costs	X
Total expenses	X
Total expenses	(X)
Profit before tax	X
Tax expense	(X)
Net income	X

2.99 The function of expense format is also called the cost of sales format. An entity that uses this format classifies expenses according to their function within the entity; that is, in production or in selling, general, or administrative activities. For example, the entity using this format would include depreciation expense on productive assets in cost of sales and depreciation expense on assets used in administrative activities, such as the headquarters building, in selling, general, or administrative expenses. When an entity uses this format, it should, at a minimum, disclose cost of sales separately from other expenses. This format can provide more relevant information to financial statement users, but this method also requires considerable judgment to allocate expenses and may require arbitrary allocations. The following is an example of the function of expense method of classification as presented on an income statement.

Revenue	X
Cost of sales	(X)
Gross profit	X
Other income expenses	
Marketing expenses	(X)
General and administrative expense	(X)
Other operating income	X
Other operating expenses	(X)
Operating income	X
Finance income	X
Finance costs	(X)
Profit before tax	X
Tax expense	(X)
Net income	X

2.100 When using the function of expense or cost of sales format, an entity should provide additional disclosures regarding the nature of expenses, including employee benefits expense and depreciation and amortization expense.

2.101 An entity's choice of the nature of expense or the function of expense format depends upon its historical and industry factors as well as its nature and the expectations of users of its financial statements. Each format has merit for different types of entities, and companies in the same industry may choose to use a different format. Although both presentation formats provide useful information, management should select the method that is reliable and most relevant and understand that the function of expense requires additional disclosures, as described in the previous paragraph.

Other Comprehensive Income

2.102 In addition to the items required or permitted to be presented as other comprehensive income in accordance with other IFRSs, an entity should disclose the amount of income tax relating to each component of other comprehensive income, including reclassification adjustments, either in the statement of profit or loss and other comprehensive income or in the notes. An entity may present items of other comprehensive income either

a. net of related tax effects, or

b. before related tax effects, showing one aggregate amount of income tax relating to those items.

2.103 An entity should also disclose reclassification adjustments related to components of other comprehensive income. *Reclassification adjustments* are amounts previously recognized in other comprehensive income that have been reclassified to profit or loss in accordance with the requirements of other IFRSs. An entity recognizes a reclassification adjustment with the related component of other comprehensive income in the period that the entity reclassifies to profit or loss an amount previously recognized in other comprehensive income.

2.104 For example, the entity recognizes a reclassification adjustment on derecognition of an available for sale financial asset for the net amount of unrealized gains and losses it recognized in other comprehensive income in the current or prior periods. The entity removes the net unrealized gain (or loss) on the available for sale financial asset from other comprehensive income in the same period in which it recognizes the net gain (or loss) in profit or loss so that it does not recognize the net gain (or loss) twice in total comprehensive income.

2.105 An entity can disclose reclassification adjustments either by explicit presentation in the statement of profit or loss and other comprehensive income or by disclosure in the notes. When an entity discloses reclassification adjustments in the notes, an entity presents the components of other comprehensive income net of any related reclassification adjustments.

2.106 Examples of reclassification adjustments include disposal of a foreign operation or when a hedged forecast transaction affects an entity's profit or loss. However, an entity does not recognize a reclassification adjustment for the following:

- Changes in a revaluation surplus recognized in accordance with IAS 16 or IAS 38, *Intangible Assets*. An entity subsequently transfers changes in the revaluation surplus directly to retained earnings either as it uses or recognizes the asset. These changes are never recognized in profit or loss.
- Remeasurements of the net defined benefit liability (asset) recognized in other comprehensive income in accordance with IAS 19, *Employee Benefits*; for example, gains or losses on changes in actuarial assumptions. An entity should not reclassify these remeasurements to profit or loss, but it may transfer amounts recognized in other comprehensive income with equity.

Information Presented Either in the Statement or the Notes

2.107 An entity should disclose the nature and amount of income or expense items separately when they are material.

2.108 Circumstances in which the entity should separately disclose material items of income and expense include the following:

- Write-downs of inventories to net realizable value and PP&E to recoverable amount, as well their applicable reversal
- Restructuring of an entity's activities and reversals of any provisions for the costs of the restructuring
- Disposals of items of PP&E
- Disposals of investments
- Discontinued operations
- Litigation settlements
- Reversals of other provisions

Statement of Changes in Equity

2.109 An entity should present a statement of changes in equity and include the following information:

a. Total comprehensive income for the period, separately displaying the total amounts attributable to

  i. noncontrolling interests; and

  ii. owners of the parent.

b. For each component of equity,

  i. the effects of retrospective application or retrospective restatement the entity recognized in accordance with IAS 8;

  ii. a reconciliation of the carrying amount at the beginning and end of the period, separately disclosing changes resulting from

    (1) profit or loss;

    (2) other comprehensive income;

    (3) transactions with owners in their capacity as owners, separately presenting

      (a) contributions by owners,

      (b) distributions to owners, and

      (c) changes in ownership interests in subsidiaries that do not result in a loss of control.

Information Presented in Either the Statement or the Notes

2.110 An entity should present either in the statement of changes in equity or in the notes to the financial statements:

- For each component of equity, an analysis of other comprehensive income by item, as described in paragraph 2.109*b* related to transactions with owners
- The amount of dividends recognized as distributions to owners during the period, and the related amount of dividends per share

2.111 Examples of a component of equity include the following:

- Class of capital stock
- Additional paid-in capital
- Treasury stock
- Accumulated other comprehensive income, which could be further disaggregated (for example, foreign currency translation, revaluation reserve)
- Retained earnings

2.112 The overall change in equity (net assets) during a period represents the total amount of income and expense, including gains and losses, generated by an entity's activities during that period, unless the change results from a transaction with owners in their capacity as owners and directly related transaction costs. Such transactions include issues of capital stock, reacquisitions of the entity's own equity instruments, and dividend distributions.

2.113 IAS 8 requires an entity to recognize the following retrospective changes to the opening balance in retained earnings, to the extent practicable:

- Retrospective adjustment for the effect of changes in accounting policies, unless another IFRS provides alternative transitional provisions
- Retrospective restatement to correct an error

2.114 Although both retrospective adjustments and retrospective restatements adjust the opening balance of retained earnings, neither are changes in an entity's equity, other than when IFRSs require retrospective adjustment to another component of equity. An entity should present the total amount of any adjustment to a component of equity, including retained earnings, which results from changes in accounting policies separately from error corrections. The entity discloses these adjustments for the beginning of the period and each prior period presented.

Notes

Contents and Structure

2.115 In the notes section of the financial statements, an entity should

- present information about the basis of preparation of the entity's financial statements, and the specific accounting policies applied in accordance with paragraphs 2.118–.122 of this chapter.
- disclose information required by IFRSs that the entity has not presented elsewhere in the financial statements.
- provide information that is relevant to the understanding of the financial statements that the entity has not presented elsewhere in the financial statements.

2.116 An entity should, as far as practicable, present the notes in a systematic manner and should cross-reference each item in the statements that comprise a complete set of financial statements to any related information in the notes.

2.117 To assist users in understanding the information provided in the entity's own financial statements and in comparing them with the financial statements of other entities, an entity normally presents the notes in the following order:

- An explicit, unreserved statement of compliance with IFRSs
- A summary of the significant accounting policies the entity applied

- Information that supports items presented in the statements of financial position, the statement of profit or loss and other comprehensive income, in the separate income statement, if presented, and in the statements of changes in equity and of cash flows, in the order in which each line item is presented in the statement
- Other disclosures, including the following:
  - Contingent liabilities and unrecognized contractual commitments, in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
  - Nonfinancial disclosures (for example, the entity's financial risk management objectives and policies) in accordance with IFRS 7

Disclosure of Accounting Policies

2.118 The entity should disclose the following in its summary of significant accounting policies:

- Basis or bases of measurement used in preparing its financial statements (for example, historical cost, current cost, net realizable cost, fair value, or recoverable amount)
- Other accounting policies the entity used that are relevant to an understanding of its financial statements

2.119 An entity discloses the measurement bases it used because these bases could significantly affect a user's analysis. If an entity uses more than one measurement basis, management should indicate the categories of assets and liabilities to which each measurement basis applies.

2.120 When determining whether or not to disclose a particular accounting policy, management should consider whether including that disclosure will assist users in understanding how transactions, other events, and conditions are reflected and reported in their financial statements. When an entity has the option of applying different accounting policies to a particular transaction or financial statement line item, its disclosure of the policy selected is especially helpful to financial statement users. For example, in accordance with IAS 16, an entity may use more than one measurement basis for different classes of PP&E, such as revalued amount for land and building and historical cost for the other classes.

2.121 The nature of an entity's operations may be significant enough to require the disclosure of a particular accounting policy, even when the amounts for the current and prior periods are not material. Additionally, the disclosure of each significant accounting policy is appropriate even if not required by a specific IFRS, but the entity selects and applies that policy in accordance with the guidance in IAS 8.

2.122 In its summary of significant accounting policies or other notes, an entity should also disclose judgments, other than those involving estimations, that management made when applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements. Examples of these types of judgments include the following:

- Judgments made when determining whether it controls another entity, in accordance with IFRS 12, *Disclosure of Interests in Other Entities*
- Criteria applied to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of these properties is difficult, in accordance with IAS 40
- Judgments made when determining if and when an entity transferred to another entity substantially all the significant risks and rewards of ownership of financial assets and leased assets
- Judgments made when determining if, in substance, a particular sale of goods is a financing arrangement that does not rise to recognition of revenue
- Judgments made when determining if the substance of the relationship between the entity and a special purpose entity indicates that the entity controls the special purpose entity

Sources of Estimation Uncertainty

2.123 An entity should disclose the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. (Note that the disclosure requirements in paragraph 2.122 of this chapter regarding the judgments made when applying the entity's accounting policies do not apply to disclosures of sources of estimation uncertainty.)

2.124 For example, an entity makes the estimates when testing assets for impairment when

- there is a lack of recently observable market prices necessary to measure the recoverable amount of classes of PP&E.
- technological obsolescence affects its inventories or PP&E.

2.125 An entity makes estimates about its obligations when

- provisions are subject to the future outcome of litigation in progress.
- measurement of pension obligations requires the entity to determine risk adjustments to cash flows or discount rates, future changes in salaries, and future changes in prices affecting other costs.

2.126 As the number of variables and assumptions affecting a possible future resolution about uncertainties increases, management's judgments become more complex and subjective. Accordingly, there is also the potential for a consequential material adjustment to an asset and liability's carrying amount.

2.127 However, if, at the end of the reporting period, an asset or liability is measured at fair value based on a quoted market price in an active market for an identical asset or liability, the entity is not required to disclose its assumptions about estimation uncertainty for that asset or liability even if there is significant risk that its carrying amounts might materially change within the next financial year. These changes in quoted prices in an active market are not a function of management's assumption or other sources of estimation uncertainty.

2.128 The nature and extent of the information management provides about estimation uncertainty should vary based on the assumptions made, the complexity of the estimation uncertainty, and other circumstances. The following are examples of disclosures an entity should make:

- The nature of the assumption or other estimation uncertainty
- The sensitivity of carrying amounts to the methods, assumptions, and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty with respect to the carrying amounts of the assets and liabilities affected and the range of reasonably possible outcomes within the next financial year
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved

2.129 An entity is not required to disclose budgeted information or forecasts that its management used in making disclosures about sources of estimation uncertainty.

2.130 When it is impracticable to disclose the possible effects of an assumption or other source of estimation uncertainty, an entity should disclose that it is reasonably possible, on the basis of existing knowledge, that outcomes within the next financial year that are different from the assumption could require a material adjustment to the carrying amount of the asset or liability affected. However, in all cases, an entity should disclose the nature and carrying amount of the specific asset or liability, or the class of assets or liabilities, affected by the assumption.

2.131 Other IFRSs may require disclosure of assumptions that would otherwise be required in accordance with IAS 1. These include the following disclosures:

- Specified circumstances and major assumptions concerning future events affecting classes of provisions required in accordance with IAS 37

- Significant assumptions an entity uses in estimating the fair values of financial assets and financial liabilities that are carried at fair value are required in accordance with IFRS 7
- Significant assumptions that the entity uses in estimating the fair values of revalued items of PP&E as required in accordance with IAS 16

Capital

2.132 An entity should disclose the following information to enable users of an entity's financial statements to evaluate an entity's objectives, policies, and processes for managing its capital:

- Qualitative information about the entity's objectives, policies, and processes for managing capital, including the following:
  - Description of what the entity manages as capital
  - Nature of externally imposed capital requirements, if any, and how those requirements are incorporated into the management of the entity's capital
  - How the entity is meeting its objectives for managing its capital
- Summary quantitative data about what the entity manages as capital
- Any changes to the preceding qualitative and quantitative information from the previous period
- Whether during the period the entity complied with any externally imposed capital requirements
- When the entity has not complied, the consequences of noncompliance

2.133 What an entity manages as capital may differ from what is recognized as capital on the statement of financial position. For example, an entity may regard some financial liabilities as part of capital, including preference shares that meet the definition of a liability or some forms of subordinated debt. Others may exclude some components of equity from their definition of capital (for example components arising from cash flow hedges).

2.134 An entity may manage capital in a variety of ways, subject to different capital requirements. When an aggregate disclosure of an entity's capital requirements and how it manages capital would not be useful or would distort a user's understanding of an entity's capital resources, the entity should disclose separate information for each capital requirement to which it is subject. For example, a large diversified multination financial institution may include subsidiaries subject to insurance and banking regulations in a number of jurisdictions with quite different capital requirements for each subsidiary.

Puttable Financial Instruments Classified as Equity

2.135 An entity should disclose the following information for puttable financial instruments classified as equity, to the extent it has not disclose this information elsewhere:

- Summary quantitative data about the amount classified as equity
- The entity's objectives, policies, and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period
- The expected cash outflow on redemption or repurchase of that class of financial instruments
- Information about how it determined the expected cash outflow on redemption or repurchase

Other Disclosures

2.136 An entity should disclose the following amounts in the notes of the financial statements:

- Dividends proposed or declared before the financial statements were authorized for issue, but not recognized as a distribution to owners during the period, including the related amount per share
- Any unrecognized cumulative preference dividends

2.137 If not disclosed elsewhere in information published within the financial statements, the entity should disclose the following:

- The domicile and legal form of the entity, its country of incorporation, and the address of its registered office, or principal place of business, if different from the registered office
- A description of the nature of the entity's operations and its principal activities
- The name of the parent and the ultimate parent of the group
- If the entity is a limited life entity, information regarding the length of its life

Chapter 3

Inventory

Overview

3.01 This chapter describes the accounting treatment for inventories, including determining

a. the amount and timing of the initial recognition of an inventory cost as an asset,

b. the amount of the subsequent expense recognized when related revenues are recognized, and

c. when the asset should be tested for impairment and an expense recognized for any adjustment to net realizable value.

3.02 This chapter also addresses the measurement of inventory, providing cost formulas used to assign costs, along with presentation and disclosure guidance for assets that fall within the scope of the inventory definition.

3.03 *Inventories* are assets that are

- held for sale in the ordinary course of business;
- used in the process of production for sale; or
- materials or supplies to be consumed in the production process or in the rendering of services.

Summary of Select Accounting Guidance

3.04 International Accounting Standard (IAS) 2, *Inventories*, is the primary accounting literature for inventories, unless another standard or requirement permits a different accounting treatment.

Scope and Scope Exceptions

3.05 This chapter and IAS 2 provide guidance for all assets that are classified as inventory, including the following:

- Intangible assets held for sale in the ordinary course of business
- Investment properties intended for sale in the ordinary course of business or in the process of construction or development for such sale
- Supplies or materials to be consumed in the production process or in the rendering of services

3.06 The scope of IAS 2 does not apply to the following:

- Biological assets related to agricultural activities and produce at the point of harvest. The guidance found in IAS 41, *Agriculture*,[1] is applicable to these assets.
- Work in progress arising from construction contracts, including directly related service contracts. The guidance found in IAS 11, *Construction Contracts*,[2] is applicable these assets.
- Financial instruments. The guidance found in IAS 32, *Financial Instruments: Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*,[3] is applicable to these assets. Refer to chapter 17, "Financial Instruments," of this book for additional information.

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[1] Guidance for agricultural activities and produce is beyond the scope of this book.

[2] Guidance for construction contracts is beyond the scope of this book.

[3] International Financial Reporting Standard 9, *Financial Instruments*, issued in October 2010, will replace International Accounting Standard 39, effective January 1, 2015.

3.07 The guidance in this chapter and IAS 2 does not apply to the measurement of inventories held by entities in certain industries that measure their inventories in accordance with the following well-established industry practices:

- *Net realizable value*. Producers of agricultural and forest products, agricultural produce after harvest, and minerals and mining products.
- *Fair value less cost to sell*. Commodity broker-traders.

3.08 However, these entities should apply both the recognition and disclosure guidance in this chapter and IAS 2 to these inventories.

3.09 Spare parts and servicing equipment are often carried as inventory and recognized in profit or loss when used. However, when such items meet the definition of *property, plant, and equipment*[4] (PP&E), the entity should classify them as PP&E and account for them in accordance with IAS 16, *Property, Plant and Equipment*. Guidance for major spare parts and servicing equipment can be found in paragraph 8 of IAS 16 and chapter 5, "Property, Plant, and Equipment," of this book.

Recognition and Measurement

3.10 An entity should recognize the cost of an inventory item as an asset when it can measure the cost reliably and it is probable that the item is a source of future economic benefits to the entity. An entity measures the item of inventory at the lower of cost or net realizable value.

3.11 The entity recognizes an expense (usually referred to as cost of sales or cost of goods sold) for the carrying amount of inventories sold in the same period the entity recognizes the related revenue.

3.12 The entity also recognizes an expense (loss) for the amount of any write-down of inventories to net realizable value in the period the write-down or loss occurs.

3.13 Subsequent reversals of any write-down of inventories arising from an increase in net realizable value are recognized as a reduction of the expense related to inventory in the period the reversal occurs.

Purchases

3.14 Initially, inventories are measured at cost. The costs of the purchase of inventories, as described in paragraph 11 of IAS 2, include the following:

- Purchase price, net of rebates or other discounts
- Import duties
- Other nonrefundable taxes
- Costs directly attributed to the purchase of finished goods, services, or raw materials, including handling and delivery costs

Conversion Costs

3.15 In addition to the cost of the purchase of inventory, other costs are incurred for the conversion of inventory from one classification to another, such as the conversion of raw materials to finished goods. These conversion costs include the following:

- Direct labor.
- Fixed indirect production costs, including manufacturing, depreciation, utilities, maintenance, and factory management and administration. These costs remain relatively fixed regardless of production volume.
- Variable indirect production costs, such as indirect material or labor. These costs generally vary based upon production volume.

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[4] Property, plant, and equipment are tangible items that (*a*) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (*b*) are expected to be used during more than one accounting period.

3.16 Usually, fixed production costs are allocated to conversion cost based on the normal capacity (or volume) of the production facilities. An entity can allocate fixed production costs to conversion costs based on actual levels of production when actual approximates normal capacity. The entity allocates the same amount of fixed overhead cost to each unit of production even when production is low or the factory is idle. The entity recognizes any fixed overhead cost that is not allocated to units as an expense in the period the overhead was incurred. However, when abnormally high production volume occurs within a period, the entity decreases the amount of fixed overhead allocated to each unit of production so that inventories are not measured above cost.

3.17 The following example illustrates the calculation of the overhead cost allocation under both low and abnormally high production volume scenarios.

Example 3-1: Allocation of Fixed Production Overhead Cost

A manufacturer incurs fixed production overhead costs of currency units (CU) 200,000 and normally produces 100,000 units. Therefore, the manufacturer calculates a per unit fixed production overhead rate of CU 2.00:

Fixed Production Overhead Rate:	
Fixed production overhead costs incurred	CU 200,000
÷ Expected production volume (normal capacity)	100,000
= Per unit allocation rate	CU 2.00

Actual Low Production Volume

Assume the plant's actual production volume is only 60,000 units. Based on the fixed production overhead rate of CU 2.00, only CU 120,000 was allocated to production, leaving a CU 80,000 of unallocated overhead:

Fixed Production Overhead Cost:	
Incurred during the period	CU 200,000
Allocated to units produced (CU 2.00 × 60,000 units)	(120,000)
Unallocated	CU 80,000

Because the actual volume was lower than normal, the entity expenses the amount of unallocated overhead, CU 40,000, in the period the fixed production overhead cost was incurred.

Actual Production Volume is Abnormally High

Assume the plant's actual production volume was 200,000 units. In contrast to the situation when the production volume was lower than normal, the entity recalculates the per unit fixed production overhead rate as follows:

Fixed Production Overhead Cost Allocation Rate:	
Incurred during the period	CU 200,000
÷ Actual units produced	200,000
= Revised overhead rate	CU 1.00

Therefore, because the total fixed production cost incurred during the period is allocated to the actual units produced rather than the expected or normal units produced, carrying value of inventory does not exceed its actual cost.

Variable production overhead costs are allocated to each unit of production on the basis of the actual use of the production facilities.

3.18 The production process sometimes produces more than one product simultaneously. This happens, for example, when joint or by-products are produced. If the conversion costs for the production of each product cannot be separately identified, the entity should allocate costs to each product using a rational and consistent basis.

3.19 One rational and consistent method would be to allocate conversion costs based on the relative selling price of each product, either during production when the products are separately identifiable or at the completion of the production process.

3.20 When one or more of the products are immaterial (by-products) relative to the main product, the by-products are often measured at their net realizable value and deducted from the cost of the main product. Because the costs deducted are immaterial, the carrying value of the main product is not materially different from its cost.

3.21 An example follows of the allocation of joint costs based upon relative sales values at completion of the production process.

Example 3-2: Allocation of Joint Costs

A manufacturer produces and sells two products. Product A has a selling price of CU 4.00 and Product B has a selling price of CU 2.00. The manufacturer produces 25,000 units of Product A and 75,000 of Product B, a total of 100,000 units. The manufacturer incurred joint conversion costs of CU 200,000 before the products could be separately identified. Therefore, the manufacturer allocates the joint costs based upon relative sales values at completion as follows:

Description	*Product A*	*Product B*	*Total*
Units produced	25,000	75,000	100,000
× Unit selling price	CU 4.00	CU 2.00	
Total expected sales revenue	CU 100,000	CU 150,000	CU 250,000
÷ Total sales revenue	CU 250,000	CU 250,000	
Allocation rate (product sales revenue ÷ total revenue)	40%	60%	100%
× Joint costs	CU 200,000	CU 200,000	
Allocated joint costs	CU 80,000	CU 120,000	CU 200,000

Other Costs

3.22 Some costs, including nonproduction costs that are necessary to bring inventories to their present location and condition, may be included in inventory cost. However, paragraph 16 of IAS 2 identifies the following specific costs that should be excluded from the cost of inventory and expensed when incurred:

- Abnormal amounts of wasted production costs, labor, and materials
- Storage costs, unless necessary in the production process before a further production stage
- Administrative overhead costs that do not contribute to bringing inventories to their present location and condition
- Selling costs

3.23 When inventory is purchased on deferred settlement terms, the entity should recognize any difference between the purchase price for normal credit terms and the amount paid as interest expense—not additional inventory cost—over the period of the financing.

3.24 Borrowing costs, as defined in IAS 23, *Borrowing Costs*, are included in the cost of inventories only under limited circumstances. All of the following criteria must be met in order for the entity to capitalize borrowing costs in inventory:

- It takes a substantial period of time to get the inventory ready for its intended use or sale.
- Borrowing costs are directly attributable to the acquisition, construction, or production of the inventory as part of the cost of the inventory.

3.25 Only actual borrowing costs incurred by the entity are eligible for capitalization. If the borrowing costs associated with inventory are included as part of an entity's overall general borrowing costs, a capitalization rate should be determined and applied to the general borrowing costs to determine the eligible borrowing costs to include in inventory. See chapter 24, "Borrowing

Costs," of this book for additional information on borrowing costs including how to determine a capitalization rate.

Service Provider Inventory Costs

3.26 Inventory costs for service providers consist primarily of labor and other costs of personnel directly engaged in providing the service, along with applicable overhead for which the entity has not yet recognized the revenue. Profit margins, nonattributable overheads, and labor and other costs related to sales and general administrative personnel are not included in the cost of inventory, but rather recognized as expenses in the period incurred.

Methods of Measurement

3.27 Inventory should be measured at the lower of cost or net realizable value subsequent to initial recognition. The following methods, among others, may facilitate measurement of cost when the results approximate cost:

- *Standard Cost Method*. This method takes into account normal levels of materials and supplies, labor, efficiency, and capacity utilization. These costs are reviewed regularly and revised, if necessary, to reflect current conditions.
- *Retail Method*. This method determines the cost of inventory based upon its sales value less the appropriate percentage gross margin. This method is frequently used to measure large amounts of rapidly changing items with similar margins when using other costing methods are impracticable. This method is often used in the retail industry, where an average percentage takes into consideration inventory that has been marked down to below its original selling price for each retail department.

Cost Formulas

3.28 The cost of inventories that are not ordinarily interchangeable, as well as goods or services produced and segregated for specific projects, should be determined using specific identification of individual costs. For example, an art gallery maintains an inventory of oil paintings, sculptures, and other works of art from different artists. Each item is unique and not interchangeable with another work of art. Therefore, the gallery maintains an inventory record that recognizes (specifically identifies) each item at its actual acquisition costs. However, some costs, such as shipping costs, may be incurred for a group of artwork and allocated to each piece of artwork as part of the costs recognized as part of a particular artwork's inventory cost.

3.29 When the cost of inventories are ordinarily interchangeable and have not been segregated and produced for a specific project, either of the following cost formulas can be used:

- First in, first out (FIFO)
- Weighted average cost

The use of the cost formula—last in, first out (LIFO)—is prohibited.

3.30 The same cost formula should be applied to all inventories that are similar in nature or use. An entity may justify the use of different cost formulas for inventories that are different in nature or use. However, geographical location by itself is not sufficient to justify use of a different cost formula.

3.31 Selecting a cost formula is considered an accounting policy. When a cost formula has been selected, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, requires that this accounting policy be applied consistently for similar transactions. A change to an accounting policy is permitted to the extent it results in the financial statements providing reliable and more relevant information, or if an accounting standard requires the change. A change in cost formula must be disclosed and applied retrospectively, unless it is impracticable, and the disclosure information will reflect this new accounting policy as if it had always been applied.

First In, First Out

3.32 The FIFO cost formula, as described in paragraph 27 of IAS 2, assumes that items of inventory purchased or produced first are sold first, and the items remaining in inventory at the end of the period are those most recently purchased or produced.

Weighted Average Cost

3.33 When using the weighted average cost formula, paragraph 27 of IAS 2 states that the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received or returned, which is commonly referred to as a moving average.

3.34 The following examples illustrate the costing of a manufacturer's ending inventory using both the FIFO and weighted average cost formulas.

Example 3-3: Costing of Manufacturer's Ending Inventory

Facts

A manufacturer has made the following purchases of raw material:

Date Purchased	*Yards Purchased*	*Cost Per Yard*	*Total Cost*
January 4, 2012	100	CU 6.00	CU 600
April 15, 2012	100	CU 7.00	CU 700
November 14, 2012	100	CU 8.00	CU 800
Goods available for sale during 2012	300		CU 2,100

Assume the manufacturer sold 200 yards during the calendar year, no other purchases occurred during the year, and the beginning inventory as of January 1, 2010, was zero.

	Units
Goods available for sale	300
Goods sold	(200)
Ending inventory	100

Therefore, the carrying value of the remaining 100 yards as of December 31, 2012, under each of the cost formulas would be as follows:

The total value of ending inventory under the FIFO formula, as of December 31, 2012, would be CU 800, and the detailed inventory records would reflect the following:

Date Purchased	*Yards Purchased*	*Cost Per Yard*	*Total Cost*
January 4, 2012	100	CU 6.00	CU 600
April 15, 2012	100	CU 7.00	CU 700
November 14, 2012	100	CU 8.00	CU 800
Yards available for sale during 2012	300		CU 2,100
Yards sold	(200)		
Ending balance	100		

200 yards of inventory sold in 2012:

100 yards from January 4, 2012, purchase:	100 units at CU 6.00 = CU 600
100 yards from April 15, 2012, purchase:	100 units at CU 7.00 = CU 700
Total cost of sales	CU 1300

100 units of remaining in inventory at December 31, 2012:

100 yards from November 14, 2012, purchase:	100 units at CU 8.00 = CU 800

The total value of ending inventory under the weighted average cost formula, as of December 31, 2012, would be CU 700, as reflected in the following computation:

Total cost of yard purchased during the 2012 year	CU 2,100
Divided by the total yards purchased	300
Average cost per yard	CU 7.00
Total yards remaining in inventory as of 12/31/2012	100
Average cost per yard	CU 7.00
Total value of ending yard inventory as of 12/31/12	CU 700

Net Realizable Value

3.35 Inventories should be carried at the lower of cost or net realizable value. *Net realizable value* is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. When there are indications that inventory costs are not recoverable (for example, due to damage, obsolescence, or selling price decline), the inventory should be restated or written down to net realizable value. This impairment test is generally performed on an item by item basis, sometimes grouping similar or related items. However, it is not appropriate to write inventories down on the basis of a classification of inventory such as by operating segment or finished goods.

3.36 Estimates of net realizable value are based on the most reliable evidence available at the time the estimate is made. The entity should consider price or cost fluctuations directly relating to events that occur after the end of the period to the extent that these events confirm conditions that existed at period end.

3.37 Materials and other supplies used in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realizable value, the materials are written down to net realizable value. In these circumstances, the replacement cost for materials is found to be the best available measure for the determination of net realizable value.

3.38 A new assessment of net realizable value is made in each subsequent period. If the circumstances that caused a write-down no longer exist or if there is clear evidence that there is an increase in net realizable value due to changes in economic circumstances, IAS 2 requires a subsequent reversal of the write-down. This reversal is limited to the original amount previously recognized as an expense.

Presentation

3.39 In accordance with IAS 1, *Presentation of Financial Statements*, inventories should be presented as a separate line item on the balance sheet classified as either current or noncurrent.

Disclosure

3.40 The entity should disclose all of the following in accordance with paragraphs 36–38 of IAS 2:

- The accounting policies adopted in measuring inventories, including the cost formula used
- The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity
- The carrying amount of inventories carried at fair value less cost to sell

- The amounts of inventories recognized as an expense during the period
- The amount of any write-down of inventories recognized as an expense in the period
- The amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period
- The circumstances or events that led to the reversal of a write-down of inventories
- The carrying amount of inventories pledged as security for liabilities

3.41 Information regarding the carrying amounts of inventories held in different classifications, such as merchandise, production supplies, materials, work in progress, and finished goods, and changes in these assets are useful.

3.42 The carrying amount of inventories recognized as an expense during the period is commonly referred to as cost of sales or cost of goods sold. This expense consists of those costs previously included in the measurement of the inventory sold, unallocated production overheads, abnormal amounts of production costs of inventories, and may include other costs, such as distribution costs.

Chapter 4

Intangible Assets

Overview

4.01 This chapter describes the accounting for certain *intangible assets*; that is, identifiable nonmonetary assets without physical substance. Some examples of intangible assets are copyrights, patents, computer software, brand names, customer lists, and development costs.

4.02 Intangible assets within the scope of this chapter are recognized only if specific criteria are met. This chapter describes how to measure the carrying amount of intangible assets that meet the specific recognition criteria, along with the required disclosures needed in an entity's financial statements.

Summary of Selective Accounting Guidance

4.03 The primary accounting literature that relates to intangible assets is International Accounting Standard (IAS) 38, *Intangible Assets*, unless another standard or requirement permits a different accounting treatment. In addition, this chapter also discusses the guidance in Standing Interpretations Committee Interpretation (SIC) 32, *Intangible Assets—Web Site Costs*.

Scope and Scope Exceptions

4.04 An entity should apply the accounting treatment described in this chapter and IAS 38 to all intangible assets, except for the following:

a. Intangible assets that are within the scope of another standard, including the following assets:

   i. Intangible assets held for sale in the ordinary course of business within the scope of IAS 2, *Inventories*, and IAS 11, *Construction Contracts*.

   ii. Deferred tax assets within the scope of IAS 12, *Income Taxes*.

   iii. Leases within the scope of IAS 17, *Leases*.

   iv. Assets that arise from employee benefits within the scope of IAS 19, *Employee Benefits*.

   v. Financial assets, as defined in IAS 32, *Financial Instruments: Presentation*.

   vi. Goodwill acquired in a business combination within the scope of International Financing Reporting Standard (IFRS) 3, *Business Combinations*.

   vii. Deferred acquisition costs and intangible assets that arise from insurer's contractual rights under insurance contracts within the scope of IFRS 4, *Insurance Contracts*.

   viii. Noncurrent intangible assets classified as held for sale, or included in a disposal group classified as held for sale, in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

b. Recognition and measurement of exploration and evaluation assets within the scope of IFRS 6, *Exploration for and Evaluation of Mineral Assets*.[1]

c. Expenditure on the development and extraction of minerals, oil, natural gas, and similar nonregenerative resources.[2]

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[1] Guidance for this specialized industry is beyond the scope of this book.

[2] See footnote 1.

d. Goodwill acquired in a business combination. Refer to IFRS 3 and chapter 16, "Business Combinations," in this book for guidance regarding goodwill acquired in a business combination.

e. Deferred acquisition costs and intangible assets that arise from an insurer's contractual rights under insurance contracts within the scope of IFRS 4.[3] Intangible assets within the scope of IFRS 4 do apply the disclosure requirements in IAS 38.

f. Noncurrent intangible assets classified as held for sale or included in a disposal group that is classified as held for sale in accordance with IFRS 5. Refer to IFRS 5 and chapter 18, "Noncurrent Assets Held for Sale and Discontinued Operations," of this book for additional guidance.

4.05 Some assets incorporate both intangible and tangible elements. For example, an intangible asset may be contained in, or possibly on, a physical substance, such as computer software placed on a compact disc. Generally, an entity accounts for a tangible element in accordance with IAS 16, *Property, Plant and Equipment*, and intangible elements in accordance with this chapter and IAS 38, unless that asset is excluded from the scope of IAS 38. If one element is an integral part of the other, an entity should use judgment in assessing which of the elements, intangible or tangible, is more significant, and account for both elements in accordance with the applicable standard. Paragraph 4 of IAS 38 provides the following examples of the latter case:

a. Computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant, and equipment in accordance with IAS 16.

b. Software that is not an integral part of the related hardware is treated as an intangible asset in accordance with IAS 38.

4.06 IAS 38 also applies to expenditures on advertising, training, start-up, as well as research and development activities. Research and development activities that involve the development of knowledge may result in an asset with physical substance. In this case, the tangible component (the prototype) is considered secondary to the intangible component (the embodied knowledge developed).

4.07 The underlying assets acquired through a finance lease may also be tangible or intangible. Although initial recognition and measurement of the asset in a finance lease is within the scope of IAS 17, subsequently, the lessee should account for a leased intangible asset in accordance with IAS 38. However, rights under licensing agreements for items such as patents and copyrights, motion picture films, video recordings, and plays and manuscripts are also within the scope of IAS 38 and excluded from the scope of IAS 17.

4.08 Refer to paragraphs 4–7 of IAS 38 for additional guidance on the scope of the standard.

Intangible Assets

4.09 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance, or enhancement of intangible resources, including the following:

a. Scientific or technical knowledge

b. The design and implementation of new processes or systems

c. Licenses

d. Intellectual property

e. Market knowledge and trademarks that may include publishing titles or brand names

4.10 Common examples of intangible resources include computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share, and marketing rights.

[3] See footnote 1.

Identifiability, Control, and Future Economic Benefits

4.11 The definition of an intangible asset requires it to be identifiable to distinguish it from goodwill. Goodwill recognized in a business combination represents future economic benefits that an entity cannot individually identify and separately recognize. Therefore, an entity can only recognize an intangible item as an intangible asset if it is identifiable and meets the definition of an asset; that is, the asset is a source of future economic benefits, controlled by the entity as a result of past events.

4.12 An asset is identifiable if either of the following criteria is met:

a. The asset is separable; that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

b. The asset arises from a contractual or other legal right regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

4.13 An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict access by others to those benefits. Generally, enforceable legal rights provide an entity with control of the future economic benefits that flow from the intangible asset. In the absence of legal rights, however, an entity may find it more difficult to demonstrate control. Sometimes, having a legally enforceable is not a necessary condition for control because the entity may control the intangible asset's future economic benefits in another way.

4.14 Future economic benefits may flow to an entity through its use of the asset to generate revenue. An entity may achieve these benefits from the sale of products or services, cost savings, or other benefits. For example, an entity may use intellectual property in a production process that may not increase future revenues but instead reduce future production costs.

4.15 Refer to paragraphs 11–17 of IAS 38 for additional guidance on assessing identifiability, control, and future economic benefits.

Recognition and Initial Measurement of Intangible Assets

4.16 An entity should recognize an intangible asset only if the intangible item meets both the definition of an asset, as described in the previous section of this chapter, and both of the following recognition criteria:

a. *Probability criteria*: It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity.

b. *Measurement reliability criteria*: The cost of the asset can be measured reliably.

4.17 With respect to the probability criteria, an entity should assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the asset's useful life.

4.18 With respect to reliable measurement, IAS 38 requires the entity to recognize an intangible asset initially at cost. There are several ways in which an entity can acquire an intangible asset. Each presents its own challenges to the entity in developing a reliable cost measurement. IAS 38 discusses the following acquisition methods in some detail:

- Separate acquisition
- Acquisition as part of a business acquisition
- Acquisition by way of a government grant
- Exchange of assets
- Generated internally

4.19 The nature of intangible assets is such that, in many cases, there are no additions to or replacement of these assets. Therefore, subsequent expenditures generally maintain the current expectation for future economic benefits rather than separately meet the definition and recognition criteria for recognition of a new intangible asset. In addition, it is often difficult for an entity to attribute subsequent expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, it is rare for an entity to include a subsequent expenditure in the carrying amount of an intangible asset, whether externally acquired or internally generated. An entity always recognizes subsequent expenditure on customer lists, brands, mastheads, publishing titles, and similar items as expenses in profit or loss as incurred, unless they meet the requirements for capitalization as part of another asset (inventory, for example). An entity normally cannot distinguish these expenditures from expenditures used to develop the entity's business as a whole.

Separate Acquisition of an Intangible Asset

4.20 If an entity acquires an intangible asset separately, it should include the following expenditures as part of the cost of that separately acquired intangible asset:

a. Purchase price paid to acquire the asset, including import duties and nonrefundable purchase taxes paid, after deducting trade discounts and rebates received

b. Any directly attributable cost incurred to prepare the asset for its intended use, such as, the cost of employee benefits, as defined in IAS 19, professional fees incurred in order to bring the asset to its working condition, and the cost of testing the assets functionality

4.21 The purchase price of a separately acquired intangible asset normally reflects expectations about the probability that the expected future economic benefits embodied in the intangible asset will flow to the entity. Therefore, even if there is uncertainty about the timing or the amount of the inflow of economic benefits, the entity should consider the probability criteria for recognition of the intangible asset to be satisfied. In addition, an entity can generally measure the cost of a separately acquired intangible asset reliably, especially when the purchase consideration is in the form of cash or another monetary asset.

4.22 The cost of an intangible asset should be its cash price equivalent if payment for the asset is deferred beyond normal credit terms. An entity recognizes the difference between the cash price equivalent and the total payments as interest expense over the financing period, unless the entity capitalize interest expense in accordance with IAS 23, *Borrowing Costs*. Refer to chapter 24, "Borrowing Costs," of this book for additional guidance relating to borrowing costs.

4.23 An entity may incur expenditures that it should not include in the cost of an intangible asset. These expenditures include the following costs:

a. Costs incurred for advertising and other promotional activities associated with the introduction of a new product or service

b. Costs associated with entering a new business location or conducting business with a new class of customer, which may include the costs of training staff

c. General and administrative overhead costs

4.24 An entity ceases capitalizing costs as part of the carrying amount of an intangible asset when it is capable of operating in the manner intended by the entity's management. Therefore, the entity does not include any costs incurred during use or redistribution of the intangible asset in the asset's carrying amount. For example, an entity should not include the following in the asset's carrying amount:

a. Costs incurred by management while the intangible asset is capable of operating as intended but before it has been placed into use

b. Initial operating losses associated with the intangible asset, such as those incurred while demand for the asset's output builds up

4.25 When an intangible asset is under development, an entity may undertake activities that are not necessary to get the asset ready for its intended use. Therefore, an entity recognizes any income or related expenses of these incidental operations immediately in profit or loss within the relevant line items of income and expense.

Acquisition of an Intangible Asset in a Business Combination

4.26 When an intangible asset is acquired in a business combination, the entity measures cost as its fair value at the date of acquisition, in accordance with IFRS 3. The acquired intangible asset's fair value already reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity, even if there is uncertainty about the timing or the amount of the inflow. Therefore, an entity always considers intangible assets acquired in a business combination to have satisfied the probability criteria for recognition in IAS 38. As long as an intangible asset acquired in a business combination is separable, or arises from a contractual or other legal right, the entity will have sufficient information to reliably measure the intangible asset's fair value. Therefore, an entity also considers an intangible asset acquired in a business combination to have satisfied the measurement criteria in IAS 38.

4.27 An acquirer recognizes an intangible asset separately from goodwill at the acquisition date, whether or not the acquired entity had recognized the asset prior to the business combination. For example, an entity recognizes an in-process research and development project, acquired as part of the assets in a business combination, as an asset separate and apart from goodwill as long as the intangible item meets the definition of an asset and the recognition criteria described previously in this chapter.

4.28 When an entity acquires an intangible asset in a business combination that is separable only in combination with a related contract, identifiable asset, or liability, the entity should recognize the asset together with the related item separately from goodwill.

4.29 An entity may also recognize a group of complementary intangible assets; for example, trademarks acquired in a business combination as a single asset providing the individual assets have similar useful lives.

4.30 Refer to IFRS 13, *Fair Value Measurement*, for additional guidance on determining fair value.

Acquisition By Government Grant

4.31 An entity may acquire an intangible asset by way of a government grant, for either nominal or no consideration. These intangible assets may include airport landing rights, licenses to operate television or radio stations, rights to access restricted resources, or quotas. An entity may initially recognize both the intangible asset and related government grant either at

a. fair value, or

b. nominal amount plus any expenditure directly attributed to the preparation of the intangible asset for its intended use, in accordance with IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

4.32 Refer to chapter 12, "Accounting for Governmental Grants and Disclosure of Governmental Assistance," of this book for detailed guidance regarding the accounting for governmental grants.

Exchanges of Assets

4.33 An entity may acquire an intangible asset in exchange for another nonmonetary asset or assets, or by a combination of monetary and nonmonetary assets.

4.34 The cost of the exchanged intangible asset is measured at fair value of the asset given up, unless the fair value of the asset received is more clearly evident, and

a. the exchange transaction lacks commercial substance, or

b. the fair value of neither the asset received nor the asset given up can be measured reliably.

4.35 A condition for recognition of an intangible asset in an exchange is reliable measurement of its fair value. IAS 38 states that the fair value of an intangible asset is reliably measureable if either the *a.* variability in the range of reasonable fair value measurements is not significant for that asset, or

b. probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

4.36 If the entity cannot measure the acquired asset at fair value, the entity measures its cost as the carrying amount of the asset given up. The timing of derecognition of the asset given up does not affect the measurement of the intangible asset acquired.

4.37 An entity determines whether the exchange transaction has commercial substance by considering the extent to which the entity expects future cash flows to change as a result of the exchange transaction. Commercial substance exists in an exchange transaction if

a. the configuration (timing, amounts, and risks) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

b. the entity-specific value of the portion of the entity's operations affected by the transaction changed as a result of the exchange; and

c. the difference in either (*a*) or (*b*) is significant relative to the fair value of the assets exchanged.

4.38 When determining if there has been a change, the entity-specific value of the portion of the entity's operations affected by the transaction should reflect post-tax cash flows, which may be clear without performing detailed calculations.

Internally-Generated Goodwill

4.39 An entity does not recognize internally-generated goodwill as an asset.

4.40 Internally-generated goodwill is not an identifiable resource controlled by the entity nor can the entity measure its cost reliably. Internally-generated goodwill is neither separable nor does it arise from contractual or other legal rights.

4.41 An entity may incur expenditures to generate future economic benefits that do not result in the creation of an intangible asset. Often these expenditures are described as contributing to an entity's internally-generated goodwill. However, the entity does not recognize these expenditures as an asset, but expenses them as incurred.

4.42 The difference between the carrying amount of an entity's identifiable net assets and the entity's market value at any time may capture a range of factors affecting its fair value, but this difference does not represent the cost of any intangible assets that it controls.

Internally-Generated Intangible Assets

4.43 When assessing whether an internally-generated intangible asset qualifies for recognition, an entity may find it difficult to determine the cost of an internally-generated intangible asset reliably because it cannot

- determine whether or when the identifiable asset will generate expected future economic benefits.
- distinguish the cost of generating the intangible asset internally from the cost of either maintaining or enhancing the entity's internally-generated goodwill, or running day-to-day operations.

4.44 To qualify for recognition, due to the difficulties an entity encounters when assessing if an internally-generated intangible asset qualifies for recognition, these assets will have to comply with the additional requirements in paragraphs 4.47–.51 and 4.56–.59 of this chapter, in addition to the general requirements for the recognition and initial measurement of an intangible asset described in paragraph 4.16.

4.45 To assess whether an internally-generated asset meets the recognition criteria, an entity classifies the generation of the asset into the following phases:

- Research phase
- Development phase

4.46 When an entity cannot distinguish between the research phase and the development phase of an internal project to create an intangible asset, the entity treats expenditures on that project as if they were incurred during the research phase only.

Research Phase

4.47 An entity should not recognize an intangible asset that arises from research or the research phase of an internal project because an entity cannot demonstrate that such intangible assets will generate probable future economic benefits. An entity recognizes an expense in profit or loss for expenditures on research or on the research phase of an internal project. Examples of research include the following:

- Activities aimed at obtaining new knowledge
- Search for, evaluation, and final selection of applications of research findings or other knowledge
- Search for alternatives for materials, devices, products, processes, systems, or services
- Formulation, design, evaluation, and final selection of possible alternatives for new or improved materials, devices, products, processes, systems, or services

Development Phase

4.48 An entity should recognize an intangible asset that arises from development or the development phase of an internal project if, and only if, the entity can demonstrate all of the following conditions are met:

- *Technical feasibility*. The entity has the technical ability to complete the intangible asset so that it will be available for use or sale.
- *Intention*. The entity intends to complete the intangible asset in order to use or sell it.
- *Ability*. The entity has the ability to sell or use the intangible asset.
- *Resource availability*. The entity can demonstrate that it has adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset.
- *Probability criteria*. The entity can demonstrate the asset's commercial feasibility and how it will generate probable future economic benefits; that is, the entity can demonstrate either
  - the existence of a market for the intangible asset or its output, or
  - the usefulness of the intangible asset, if the entity will use the asset internally.
- *Measurement reliability criteria*. The entity can demonstrate it has the ability to measure reliably the expenditure attributable to the intangible asset during its development.

4.49 The development phase of a project is further advanced than the research phase. Therefore, an entity can sometimes identify an intangible asset in the development phase because it can demonstrate the asset will generate future economic benefits. Examples of some development activities include the following:

- Design of tools, jigs, molds, and dies involving new technology
- Design, construction, and testing of preproduction or pre-use prototypes and models
- Design, construction, and operation of a pilot plant that is not of a scale economically feasible for commercial production
- Design, construction, and testing of a chosen alternative for new or improved materials, devices, products, processes, systems, or services

4.50 An entity can often reliably measure the cost of generating an intangible asset internally by using an entity's costing systems. For example, an entity's costing system will record salaries and other expenditures incurred in securing copyrights or licenses or the developing of computer software.

4.51 An entity should not recognize internally-generated brands, mastheads, publishing titles, customer lists, and similar items as intangible assets because the expenditures for these items cannot be distinguished from the cost of developing an entity's business as a whole.

Internal Expenditures on Development and Operation of an Entity's Own Website

4.52 An entity may incur internal expenditures on the development and operation of its own website for internal or external access. Similar to research and development projects, an entity develops its website in stages and includes the following:

- Planning, which includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives, and determining preferences
- Application and infrastructure development, which includes obtaining a domain name, purchasing and developing hardware and software, installing applications, and testing
- Graphical design development, which includes designing the appearance of the web pages
- Content development, which includes creating, purchasing, preparing, and uploading information on the website before development is complete

4.53 The operating stage occurs after the entity completes the website and may include maintenance and enhancements to the applications, infrastructure, graphical design, and content.

4.54 The following accounting issues for an entity to address when accounting for such expenditures are identified in SIC 32:

- Whether the website is an internally-generated intangible asset subject to the requirements of IAS 38
- The appropriate accounting treatment

4.55 SIC 32 does not apply to the following:

- Expenditures on purchasing, developing, and operating hardware, which is accounted for in accordance with IAS 16
- Intangible assets held for sale in the ordinary course of business, including websites developed for sale to another entity, which are accounted for in accordance with IAS 2 or IAS 11, as appropriate
- Leases within the scope of IAS 17

4.56 According to paragraph 7 of SIC 32, an entity's website that has internal or external access is considered an internally-generated intangible asset subject to the requirements of IAS 38. Therefore, an entity recognizes such a website as an intangible asset if, and only if, in addition to meeting the general requirements of IAS 38 for recognition and initial measurement, the entity satisfies the requirements in IAS 38 that specifically address recognition of internally-generated intangible assets.

4.57 The entity should consider the website's stage of development and postdevelopment when determining the appropriate accounting treatment. The following examples provide comparable assessments the entity should make in these circumstances:

- An entity should recognize an expense as incurred expenditures acquired during the website's planning stage. Refer to paragraph 4.47 for guidance on accounting for expenditures during the research phase.
- To the extent that the entity develops content other than for advertising or promoting its own products and services, the application and infrastructure development stage, graphical design stage, and content development stage are similar in nature to the development phase described in paragraphs 4.48–.51. When these expenditures occur after the recognition criteria described in paragraph 4.16 of this chapter are met, can be directly attributed, and are necessary for the creation, production, or preparation of the website, allowing it to operate in a manner intended by management, the entity should include these expenditures in the cost of the website and recognized as an intangible asset.

- An entity should expense as incurred expenditures acquired during the content development stage, to the extent that the content is developed to advertise and promote the entity's own products and advertising.
- An entity should expense as incurred expenditures acquired during the operating stage once the website development is complete unless the recognition criteria described in paragraph 4.16 has been met.

4.58 In addition to these examples, SIC 32 contains an appendix that provides illustrative examples.

4.59 After an entity recognizes a website as an intangible asset, it should measure the asset in accordance with paragraph 4.18 of this chapter. According to paragraph 10 of SIC 32, an entity's best estimate of its website's useful life should be short.

Subsequent Expenditure on an Acquired In-Process Research and Development Project

4.60 An entity should account for a research and development expenditure, in accordance with the preceding guidance, for recognition of an internally-generated intangible asset when both of the following conditions are met:

- The expenditure relates to an in-process research and development project that the entity
  - acquired separately, or
  - acquired in a business combination; and
  - recognized as an intangible asset.
- The entity incurred the expenditure after the acquisition of that project.

4.61 When the entity applies the recognition criteria for an internally-generated intangible asset to the subsequently incurred expenditure on an acquired in-process research and development project, it should recognize the expenditure as an

- expense when incurred if the expenditure is for research.
- expense when incurred if it is a development expenditure that does not satisfy the intangible asset recognition criteria described in paragraph 4.16 of this chapter.
- add to the carrying amount of the acquired in-process research and development asset, if it is a development expenditure that satisfies the recognition criteria described in paragraph 4.16 of this chapter.

Measuring the Cost of an Internally-Generated Intangible Asset

4.62 The cost of an internally-generated intangible asset is the sum of expenditures incurred from the date when the intangible asset first met the recognition criteria in IAS 38. IAS 38 prohibits reinstatement of expenditures previously recognized as an expense.

4.63 An internally-generated intangible asset includes all costs directly attributable and necessary to create, produce, and prepare the asset so that it is capable of operating in the manner intended by management. Directly attributable costs may include the following:

- Materials and services used or consumed when generating the intangible asset
- Employee benefits, as defined in IAS 19, incurred from the generation of the intangible asset
- Fees incurred to register the intangible asset's legal right
- Amortization of licenses and patents that are used to generate the intangible asset

4.64 An entity accounts for borrowing costs associated with an internally-generated intangible asset in accordance with IAS 23. Refer to chapter 24 of this book for additional information regarding the treatment of borrowing costs.

4.65 However, an entity does not include the following expenditures in the cost of an internally-generated intangible asset:

- Selling, administrative, and other general overhead expenditures unless the expenditure can be directly attributed to preparing the asset for use
- Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance
- Cost of training staff to operate the intangible asset

Expense Recognition

4.66 An entity recognizes expenditures on an intangible item as an expense when incurred unless the entity

a. included the expenditure as part of the cost of an intangible asset that met the recognition criteria in accordance with IAS 38; or

b. acquired the item in a business combination, but because it could not recognize the item as a separate intangible asset, the item forms part of the amount recognized as goodwill at the acquisition date, in accordance with IFRS 3.

4.67 IAS 38 does not preclude an entity from recognizing an asset when it has paid in advance for goods or services it will receive at a later date. However, such a payment should meet the definition of an asset and the relevant recognition criteria.

4.68 IAS 38 includes the following examples of expenditures that an entity should expense as incurred:

- Cost of start-up activities, such as legal and other fees incurred in establishing a legal entity or costs of opening a new facility, unless the entity should include the cost in property, plant, and equipment in accordance with IAS 16
- Training costs
- Advertising and promotional costs, including mail order catalogs
- Cost of reorganizing or relocating all or part of the entity

4.69 Once an entity recognizes an expenditure that is related to an intangible item as an expense, it should not recognize that expenditure as part of the cost of an intangible asset at a later date.

Subsequent Measurement

4.70 After initial recognition, an entity should choose one of the following accounting policies:

- Cost model
- Revaluation model

4.71 An entity groups intangible assets of a similar nature and use in an entity's operations into a class of assets. If the entity chooses the revaluation model to account for an intangible asset, it should also account for all other assets in its class using that same model, unless there is no active market for those assets. An entity simultaneously revalues items within a class to avoid both selective revaluation of assets and reporting of amounts, representing a mix of costs and values, in the financial statements representing different dates.

Cost Model

4.72 Subsequent to an asset's initial recognition, an entity carries an intangible asset at its cost less any accumulated amortization and accumulated impairment losses.

Revaluation Model

4.73 Subsequent to an asset's initial recognition, an entity carries an intangible asset at revalued amount, which is its fair value at the date of the revaluation less any subsequent accumulated amortization and accumulated impairment losses. An entity should determine the fair value used for the revaluation of an intangible asset only by reference to an active market.

An entity should make revaluations with sufficient regularity such that the asset's carrying amount does not differ materially from its fair value at the end of the entity's reporting period.

4.74 The revaluation model prohibits the following:

- Initial recognition of an intangible asset at an amount other than cost
- Revaluation of an intangible asset that has not previously been recognized as an asset

4.75 An entity applies the revaluation model after it recognizes an intangible asset at cost. When an entity recognizes only part of an intangible asset's cost because expenditures on the asset did not meet the recognition criteria until the asset was part of the way through the research and development process, IAS 38 allows the entity to apply the revaluation model to the entire intangible asset. Additionally, an entity that received an intangible asset by way of a government grant and recognized the asset at a nominal amount may also apply the revaluation model.

4.76 Active markets for intangible assets with certain characteristics are generally uncommon. Due to the uniqueness of certain assets, active markets cannot exist. Such is the case for newspaper mastheads, brands, music and film publishing rights, or patents or trademarks, even though these assets are bought and sold and contracts negotiated between willing buyers and sellers. In contrast, active markets may exist for freely transferable licenses for fishing, taxi, production quotas, and emission credits. However, prices for these assets are generally not available to the public and the prices paid may not provide sufficient evidence of the asset's fair value.

4.77 The volatility of the intangible assets fair value will determine the frequency of its revaluation. If the asset's fair value in revaluation differs materially from its carrying value, an entity may need to revalue more frequently. An entity may also need to revalue annually intangible assets that experience significant and volatile movements in fair value, but such revaluations are unnecessary for intangible assets with only insignificant movements in their fair value.

4.78 When an intangible asset is revalued, any accumulated amortization at the date of the revaluation is either

a. restated proportionately with the change in the gross carrying amount of the asset so that the net carrying amount of the asset after revaluation equals its revalued amount; or

b. eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset.

4.79 If an active market does not exist for an intangible asset in a class of revalued intangible assets, the entity carries the asset at cost less any accumulated amortization and accumulated impairment losses.

4.80 When the fair value of a revalued intangible asset can no longer be determined by way of an active market, the intangible asset's carrying amount is the revalued amount at the date of the last revaluation when an active market was available, less any subsequent accumulated amortization and any subsequent accumulated impairment losses.

4.81 Lack of an active market for an intangible asset may be an indication that the asset is impaired. Consequently, an entity needs to test the intangible asset for impairment in accordance with IAS 36, *Impairment of Assets*. Refer to chapter 6, "Impairment of Assets," of this book for additional guidance on impairment of assets.

4.82 When an entity can determine the fair value of the asset by reference to an active market at a subsequent measurement date, the entity applies the revaluation model from that date.

4.83 If the carrying amount of an intangible asset increases as a result of a revaluation, the entity recognizes that increase in other comprehensive income and accumulated in equity under the heading of revaluation surplus. An entity recognizes an increase in profit or loss to the extent that it is reversing a revaluation decrease for the same asset that previously recognized in profit or loss.

4.84 When the carrying amount of an intangible asset decreases as a result of a revaluation, an entity recognizes that decrease in profit or loss. An entity recognizes a decrease in other comprehensive income only to the extent of any credit balance in the revaluation surplus that relates to the asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

4.85 When an entity realizes a surplus, the entity transfers the cumulative revaluation surplus directly to retained earnings. The entity may realize the entire surplus when it retires or disposes of the intangible asset. However, the entity may realize part of surplus as the asset is used. In the latter case, the entity measures the amount of the surplus realized as the difference between amortization based on the revalued carrying amount of the asset and the amortization that it would have recognized based on the asset's historical cost. An entity does not recognize in profit or loss a transfer from revaluation surplus to retained earnings.

Useful Life

4.86 IAS 38 defines a *useful life* as

a. the period over which an entity expects an asset to be available for use, or

b. the number of production or similar units an entity expects to obtain from the asset.

4.87 The useful life of an intangible asset is either finite or indefinite. When an entity assesses that the life of an intangible asset is finite, the period the asset is used by the entity or number of production or similar units expected to be obtained by the entity should constitute its useful life. An entity accounts for intangible asset based on its useful life. An entity amortizes intangible assets with finite useful lives, but not those with indefinite useful lives.

4.88 An entity determines that an intangible asset has an indefinite useful life based on an analysis of all of the relevant factors to determine that there is no foreseeable limit to the period over which it expects the intangible asset to generate net cash inflows for the entity.

4.89 An entity considers a variety of factors when determining the useful life of an intangible asset, including the following:

- The expected usage of the asset and whether the asset could be managed efficiently by another management team
- The intangible asset's typical product life cycles and public information on estimates of useful lives of similar assets that are used in a similar way
- The intangible asset's technical, technological, commercial, or other types of obsolescence
- The stability of the industry in which the intangible asset operates along with changes in the market demand for the output from intangible asset's products or services
- The expected actions by competitors or potential competitors
- The level of maintenance expenditure required to obtain the expected future economic benefits from the intangible asset and the entity's ability and intention to reach such a level
- The period of control over the asset and legal or similar limits on the use of the intangible asset, such as the expiry dates of related leases
- Determining whether the useful life of the intangible asset is dependent on the useful life of other assets of the entity

4.90 IAS 38 clarifies that the term indefinite does not mean infinite. The useful life of an intangible asset reflects only the level of future expenditure required to maintain the asset at its current standard of performance and is based upon the entity's ability and intention to reach that level of expenditure. An entity should not conclude that an intangible asset's useful life is indefinite based upon planned future expenditures in excess of what is required to maintain the asset at the standard of performance.

4.91 Given the history of rapid changes in technology, computer software, and other related items, intangible assets are likely to have short useful lives because they are susceptible to technological obsolescence. Other intangible assets may have indefinite or long useful lives.

However, uncertainty requires an entity to estimate useful lives on a prudent basis and does not justify choosing an unrealistically short life.

4.92 The useful life of an intangible asset that arises from a contractual or other legal right cannot exceed the period of the contractual or other legal rights. Although depending upon the period over which an entity expects to use the intangible asset, its useful life may be shorter than the contractual period. If the limited term of the contractual or other legal rights can be renewed, an entity may factor expected renewals into the useful life assessment only if there is evidence to support renewal without significant cost. When an entity reacquires a right to recognize an intangible asset in a business combination, the useful life is the remaining contractual period of the contract in which the right was granted, and does not include renewal periods.

4.93 The following provides some factors that indicate the existence of the ability to renew the contractual or other legal rights that gave rise to an intangible asset without significant cost:

- Evidence exists, possibly based on experience, that the entity will renew contractual or other legal rights. If renewal is contingent upon the consent of a third party, then evidence will need to exist indicating that the third party will give its consent.
- Evidence exists that any conditions necessary to obtain renewal will be satisfied.
- Cost of renewal is not significant when compared to the future economic benefits the entity expects from renewal.

4.94 If renewal costs are significant when compared to the future economic benefits, the renewal cost, in substance, represents the cost to acquire a new intangible asset at the renewal date.

4.95 IAS 38 has accompanying illustrative examples that demonstrate how an entity determines the useful life of different intangible assets, and the subsequent accounting for those assets based on the useful life determinations.

Intangible Assets With Finite Useful Lives

Useful Life, Residual Value, and Amortization Method

4.96 An entity allocates the depreciable amount, cost less estimated residual value, of an intangible asset with a finite useful life on a systematic basis over the asset's useful life. Amortization of an intangible asset begins when the asset is available for use. For example, an intangible asset may be capable of operating in the manner intended by the entity's management when it is in the location and condition that management intends.

4.97 The amortization method used for the intangible asset should reflect the pattern in which future economic benefits are expected to flow to the entity, but if that pattern cannot be determined reliably, the entity should use the straight-line method.

4.98 An entity recognizes amortization expense in profit or loss for each period, unless another IFRS permits or requires the entity to include the expense in the carrying amount of another asset.

4.99 An entity will cease amortizing an intangible asset at the earlier of the date the entity

a. derecognizes the asset; or

b. classifies the asset as held for sale, or included in a disposal group is classified as held for sale, in accordance with IFRS 5.

4.100 IAS 38 provides an entity with a variety of amortization methods to use when allocating the depreciable amount of the intangible asset on a systematic basis over its useful life. IAS 38 lists the following available methods:

- Straight-line
- Declining balance
- Units of production

4.101 An entity should select a method based upon the expected pattern of consumption of the expected future economic benefits embodied in the asset. An entity applies this method consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits.

4.102 An entity should assume an intangible asset with a finite useful life has a residual value of zero unless

a. a third party has committed to purchase the asset at the end of its useful life; or

b. an active market for the asset exists and

  i. the entity can determine the residual value based on that active market; and

  ii. it is probable that such an active market will exist at the end of the useful life of the intangible asset.

4.103 To determine the depreciable amount of an intangible asset with a finite life, an entity should deduct the residual value from the cost of the intangible asset. A residual value other than zero implies that the entity expects to dispose of the intangible asset before the end of its economic life.

4.104 An entity bases its estimate of an intangible asset's residual value on the amount recoverable from an asset's disposal. The entity uses prevailing prices at the date of the estimate based on sales of similar assets that have reached the end of their useful life and have operated under similar conditions to those in which the entity intends to operate its asset. At each fiscal year-end, at a minimum, the entity reviews the intangible asset's residual value. The entity should account for any changes to the asset's residual value as a change in accounting estimate in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

4.105 It is possible that an intangible asset's residual value may increase to an amount that may be equal or higher than its carrying amount. If this occurs, the entity should record an amortization charge equal to zero, unless or until the residual value amount decreases below the carrying amount.

Review of Amortization Period and Amortization Method

4.106 An entity should review the amortization period and amortization method for an intangible asset with a finite useful life at least annually. As a result of the review, the entity should adjust the following:

- The amount of the amortization if the expected useful life of the asset is different from previous estimates
- The amortization method when the expected pattern of consumption of the future economic benefits embodied in the intangible asset has changed

4.107 The entity accounts for these changes as changes in accounting estimates in accordance with IAS 8.

4.108 It may become apparent over the life of an intangible asset that the estimated useful life is no longer appropriate. For example, an indication that the amortization period needs to change may be indicated by the recognition of an impairment loss.

4.109 The pattern of the future economic benefits expected to flow to an entity from an intangible asset may change over time. Examples of these circumstances are the following:

- When the use of a declining balance method of amortization is more appropriate than a straight-line method
- When the entity defers use of the rights represented by a license due to a pending action on other components of an entity's business plan that will result in the entity not receiving the economic benefits that flow from the asset until later periods

Intangible Assets With Indefinite Useful Lives

4.110 An entity does not amortize intangible assets with indefinite useful lives. Instead, the entity tests the asset for impairment annually or whenever there is an indication that the intangible asset may be impaired in accordance with IAS 36. Refer to chapter 6 of this book for additional information regarding impairment of assets.

Review of Useful Life Assessment

4.111 An entity should review the useful lives of intangible assets that are not amortized each period and determine whether circumstances or events continue to support its assessment that the asset has an indefinite useful life. If events or circumstances no longer support this assessment, the entity accounts for the change as a change in accounting estimate in accordance with IAS 8.

4.112 A change in the assessment of an asset's useful life from indefinite to finite is an indicator that the asset is impaired. As a result, in accordance with IAS 36, the entity tests the intangible asset impairment by comparing its recoverable amount with its carrying amount, and recognizes any excess of the carrying amount over the recoverable amount as an impairment loss.

Recoverability of the Carrying Amount—Impairment Losses

4.113 An entity applies the guidance in IAS 36 when determining whether an intangible asset is impaired. IAS 36 also describes how and when an entity reviews the carrying amount of the intangible asset, how it determines the recoverable amount, and when it recognizes or reverses an impairment loss. Refer to chapter 6 of this book for a detailed discussion on impairment of assets.

Retirements and Disposals

4.114 An entity should derecognize an intangible asset on disposal or when the entity no longer expects to receive future economic benefits from its use or disposal.

4.115 An entity recognizes the difference between the net disposal proceeds from the derecognized intangible asset, if any, and the asset's carrying amount as a gain or a loss in profit or loss, unless IAS 17 requires a different treatment for a sale and a leaseback.

4.116 When determining the date of the disposal of the intangible, an entity should apply the guidance in IAS 18, *Revenue*, to determine whether to recognize revenue on the sale of goods. The entity should account for the disposal of an asset through a sale and lease back transaction in accordance with IAS 17.

4.117 If the entity recognizes the cost of replacing a part of an intangible asset in its carrying amount, then the entity derecognizes the replacement part when it derecognizes the intangible asset. When it is not practicable to estimate the carrying amount of a replacement part, an entity may use the cost of the replacement as an indication of what the cost of the replacement part was at the time the entity acquired or internally generated the asset.

4.118 In a business combination, if an entity reacquires a right and that right is subsequently reissued to a third party, the entity should use the related carrying amount, if any, in determining the gain or loss on reissue.

4.119 An entity initially recognizes the consideration receivable on an intangible asset's disposal at its fair value. If payment of the receivable is deferred, the entity recognizes the consideration received at its cash price equivalent. In accordance with IAS 18, an entity recognizes the difference between the nominal amount of the consideration and the cash price equivalent as interest income reflecting the effective yield on the receivable.

4.120 An entity does not cease amortizing an intangible asset with a finite useful life when the asset is no longer used, unless the entity has fully depreciated the asset, or classified it as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5.

Disclosure

4.121 An entity should disclose in its financial statements the following information for each class of intangible asset, distinguishing between the entity's internally-generated intangible assets and its other intangible assets:

- Whether the useful lives are indefinite or finite, and, if finite
  - useful lives or the amortization rates
  - amortization methods used
  - asset's gross carrying amount and any accumulated amortization, aggregated with accumulated impairment losses, at the beginning and end of the period
- The line item or items in which any intangible asset amortization is included in the statement of profit or loss and other comprehensive income
- A reconciliation that includes the intangible asset's carrying amount at the beginning and end of the period which includes the following:
  - Additions, separately distinguishing intangible assets that were internally developed from those acquired, and from those acquired through a business combination
  - Assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals
  - Increases or decreases during the period that result from revaluations and from impairment losses recognized or reversed in other comprehensive income in accordance IAS 36
  - Impairment losses recognized or reversed in profit or loss during the period in accordance with IAS 36
  - Any amortization recognized during the period
  - Net exchange differences that arise on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity
  - Other changes in the carrying amount during the period

4.122 An entity should make the required disclosures by class of intangible assets of a similar nature and use in the entity's operations if the disclosure will result in more relevant information for the users of the financial statements. Some examples of separate classes may include the following:

- Brand names
- Mastheads and publishing titles
- Computer software
- Licenses and franchises
- Copyrights, patents, and other industrial property rights
- Service and operating rights, recipes, formulas models, designs, and prototypes
- Intangible assets under development

4.123 An entity should disclose the carrying amount of an intangible asset assessed as having an indefinite useful life and the reasons supporting that assessment. When providing this explanation, an entity should describe the significant factors used in determining that the asset has an indefinite useful life. For additional information, refer to paragraph 90 of IAS 38 for items to consider when determining factors that played a significant role in assessing whether an intangible asset has an indefinite life.

4.124 For individual intangible assets that are material to an entity's financial statements, the entity should disclose a description of the intangible asset's carrying amount and remaining amortization period.

4.125 An entity should disclose the following for intangible assets acquired through a government grant and initially recognized at fair value:

- Their amount of the fair value initially recognized
- Their carrying amount
- Whether they are subsequently measured under the cost or revaluation models

4.126 An entity should disclose the following:

- Amount of contractual commitments for the acquisition of intangible assets
- Existence and carrying amounts of intangible assets that are restricted and pledged as security for liabilities

4.127 An entity should disclose the following by class of intangible asset when it accounts for these assets at revalued amounts:

- Effective date of the revaluation
- Carrying amount of the revalued intangible assets and the carrying amount that would have been recognized had the revalued class of intangible assets been measured after recognition using the cost model

4.128 For intangible assets carried at revalued amount in the aggregate, the entity should disclose the following:

- Amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders
- Methods and significant assumptions applied in estimating the assets' fair values

4.129 It may be necessary to aggregate some classes of revalued assets into larger classes for disclosure purposes. However, an entity does not aggregate classes if aggregation would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation methods.

4.130 An entity should disclose the aggregate amount of research and development expenditures recognized as an expense. Research and development expenditure comprises all expenditures directly attributable to research or development activities.

4.131 IAS 8 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods. These changes may arise from the reassessment of an intangible asset's useful life, changes in an amortization method or changes to residual values. Refer to chapter 30, "Accounting Policies, Changes in Accounting Estimates, and Errors," of this book for additional guidance on accounting for changes in accounting estimates.

4.132 In accordance with IAS 36, an entity should provide information on impaired intangible assets in addition to the disclosures described in paragraph 4.121.

4.133 IAS 38 encourages but does not require an entity to disclose the following information:

- Description of any fully amortized intangible asset still in use
- Brief description of significant intangible assets that an entity controls but has not recognized as assets because they were acquired or generated before IAS 38 was issued in 1998, and became effective, and did not meet the recognition criteria for an intangible asset

Chapter 5

Property, Plant, and Equipment

Overview

5.01 An entity classifies its tangible, noncurrent items as property, plant, and equipment (PP&E) when the entity holds these items for the following reasons:

- Use in production or supply of goods or services
- Rental to others
- Administrative purposes

5.02 This chapter provides the accounting treatment for assets classified as PP&E, including recognition; measurement, including expense recognition and impairment; derecognition; and disclosure requirements.

Summary of Selective Accounting Guidance

5.03 The primary accounting literature related to assets classified as PP&E is International Accounting Standard (IAS) 16, *Property, Plant and Equipment*, unless another International Financial Reporting Standard (IFRS) requires or permits a different accounting treatment. When considering whether an item of PP&E is impaired, the entity applies the guidance in IAS 36, *Impairment of Assets*. Refer to chapter 6 in this book for a more detailed discussion of asset impairment.

Scope and Scope Exceptions

5.04 This chapter provides guidance for noncurrent assets that are classified as PP&E. This chapter and the scope of IAS 16 do not apply to the accounting treatment of the following:

- PP&E classified as held for sale. An entity applies the guidance in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, to determine when held for sale classification is appropriate and the accounting treatment to apply after classification.
- Exploration and evaluation of assets. An entity applies the guidance on recognition and measurement found in IFRS 6, *Exploration for and Evaluation of Mineral Resources*,[1] to these assets.
- Biological assets related to agricultural activities. An entity applies the guidance found in IAS 41, *Agriculture*,[2] to these assets.
- Mineral rights and mineral reserves such as oil, natural gas, and similar nongenerative resources.

5.05 However, an entity applies the guidance in IAS 16 and this chapter to PP&E used to develop or maintain biological assets, exploration and evaluation assets, and mineral rights and reserves.

5.06 Other guidance may require recognition of PP&E based upon approaches that differ from IAS 16. For example, IAS 17, *Leases*, requires an entity to evaluate that initial recognition of leased items of PP&E on the basis of the transfer of risks and rewards rather than only applying the asset definition and the probability and measurement reliability recognition criteria. However, the entity applies the guidance in IAS 16 and this chapter to other aspects of the accounting for these leased assets. For example, an entity applies the guidance in IAS 16 and this chapter when recognizing depreciation expense on leased assets.

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[1] Guidance regarding International Financial Reporting Standard 6, *Exploration for and Evaluation of Mineral Resources*, has not been included for discussion because it is beyond the scope of this book.

[2] Guidance regarding International Accounting Standard 41, *Agriculture*, has not been included for discussion because it is beyond the scope of this book.

5.07 In addition, an entity that uses the cost model for investment property in accordance with IAS 40, *Investment Property*, applies the guidance on the cost model in IAS 16 and this chapter. Refer to chapter 9 of this book for a discussion of the definition of and accounting for investment properties.

Recognition

5.08 An entity recognizes the cost of an item classified as PP&E when the item meets the definition of an asset and the following recognition criteria:

- It is probable that future economic benefits associated with the item will flow to the entity.
- The entity can measure its cost reliably.

5.09 An entity accounts for spare parts, standby, and servicing equipment in accordance with IAS 16 when they meet the definition of PP&E; that is, the entity expects to use them over more than one accounting period. Otherwise, in accordance with paragraph 8 of IAS 16, these items are carried as inventory and recognized in profit and loss when consumed. However, major spare parts and standby equipment qualify as PP&E when an entity expects to use them during more than one period. Similarly, if spare parts and servicing equipment can only be used in connection with an item of PP&E, they are recognized as PP&E.

Components Approach

5.10 Finally, IAS 16 requires an entity to measure and recognize depreciation separately for the components (parts) of an item of PP&E with a cost that is significant relative to the total cost of the item. Therefore, an entity allocates the amount initial recognized as the cost of the asset to the asset's significant components, even when the entity estimates the useful life and residual value of the part to be the same as the asset as a whole. When regular major inspections or overhauls are required as a condition of continuing to operate an item of PP&E, the entity should allocate a portion of the initial capitalized cost to a major inspection and overhaul component. IAS 16 and this chapter include guidance on subsequent measurement and derecognition of these components.

Initial Costs

5.11 Determining the costs an entity should recognize as part of the cost of PP&E, including aggregation of insignificant items, requires the entity to use judgment. The basic principle is that an entity should capitalize as part of the cost of a PP&E item all the directly attributable costs necessary to bring the asset to the location and condition so that it is ready to operate in the manner that management intends.

Subsequent Costs

5.12 An entity recognizes the costs of general repairs and maintenance of PP&E as an expense in profit and loss as incurred. As noted previously, the entity allocates a portion of the initial cost of an item of PP&E to significant components. When an entity replaces a component, it derecognizes any remaining carrying value and capitalizes the costs directly attributable to its replacement in accordance with the same recognition criteria applied when the asset was recognized initially.

Initial Measurement

5.13 Generally, an entity capitalizes the following costs:

- Purchase price, including import duties and other nonrefundable taxes, less any trade discounts or rebates
- The initial estimate of the costs of dismantling and removing the asset and restoring the site, under the guidance of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

5.14 Directly attributable costs may also include the following:

- Costs to initially acquire an asset, including delivery, handling, and installation costs.
- Costs to construct an asset, including site preparation, direct materials, and labor.
- Costs of testing to determine the asset's functionality, less any net proceeds from selling any products produced during this phase.
- Professional fees, such as architectural, legal, and accounting.
- Costs to subsequently replace part of, add to, or service the asset.
- Changes to existing decommissioning or restoration obligations are generally added to or deducted from the cost of the related asset. (These costs are subsequently depreciated prospectively over the remaining life of the asset.)

5.15 However, an entity should not capitalize the following costs:

- Staff training costs
- Administrative and other general overhead costs
- Costs of operating a new facility or introducing a new product or service
- Advertising, marketing, and other promotional costs
- Costs of conducting business in a new location or with a new class of customer

5.16 Consistent with the guidance in paragraphs 5.14–.15, the total cost of an item of PP&E is the cash price equivalent at the recognition date. Therefore, when payment of a cost the entity will capitalize is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest expense over the credit period unless the interest qualifies for capitalization as part of the cost of the asset under the guidance of IAS 23, *Borrowing Costs*.

5.17 When the entity acquires an item of PP&E in a nonmonetary or partially nonmonetary exchange, the entity measures the cost of the item at the fair value of either the asset received or the asset given up, whichever is more clearly evident, unless

- the transaction lacks commercial substance (refer to paragraph 25 in IAS 16 for a discussion of the characteristics of transactions with commercial substance), or
- the entity cannot measure the fair value of neither the asset received or given up reliably.

5.18 When the entity cannot measure the item received at fair value, it measures the item received at the carrying value of the item given up. An entity measures the cost of an item of PP&E held by a lessee under a finance lease in accordance with IAS 17. An entity may reduce the carrying amount of items of PP&E for government grants in accordance with IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

Subsequent Measurement

5.19 After initial recognition, an entity measures each class of PP&E according to one of the following measurement models as its accounting policy: cost or revaluation.

5.20 An asset class consists of assets that are similar in nature and used in an entity's operations. The purpose of the requirement to select a measurement model for an entire asset class is to ensure that an entity measures all assets in the class consistently.

Cost Model

5.21 Under the cost model, after recognition, an entity measures the carrying amount of an item of PP&E at its cost (initial measurement) less any accumulated depreciation and accumulated impairment losses.

Revaluation Model

5.22 Under the revaluation model, after recognition, an entity measures the carrying amount of an item of PP&E whose fair value can be measured reliably, at a revalued amount, less subsequent accumulated depreciation and subsequent impairment losses. IAS 16 defines *fair value* as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. Therefore, market value is usually fair value except when no active market exists; in this case, replacement cost may approximate fair value. An entity generally uses professionally qualified valuation experts to determine the fair value of revalued assets.

5.23 IAS 16 requires an entity to revalue measured assets using the revaluation model with sufficient regularity to ensure that the asset's carrying amount does not materially differ from its fair value at the end of the reporting period. How often an entity should revalue an asset class depends upon the volatility of changes in fair value of the revalued assets. Entities generally revalue these assets every three to five years; however, an entity may need to revalue some asset classes more frequently. When a revalued asset's carrying amount differs materially from its fair value at the end of the reporting period, IAS 16 requires the entity to do a further revaluation.

Recognition of Revaluation Increases and Decreases

5.24 Unless the entity has previously recorded revaluation decreases for an asset, it recognizes an increase in carrying amount as a result of a revaluation in other comprehensive income and in equity in an accumulated other comprehensive income account, not retained earnings. Often, this equity account is titled "revaluation surplus." However, to the extent the increase reverses a revaluation decrease recognized for the same asset that was previously recognized in profit or loss, the entity recognizes the revaluation increase in profit or loss as well.

5.25 Similarly, unless the entity has a revaluation surplus account for previously recorded revaluation increases for the asset; it recognizes a revaluation decrease in equity. To the extent that a revaluation surplus exists, the entity records revaluation decreases in other comprehensive income as a reduction of the revaluation surplus.

5.26 An entity also recognizes changes in an estimated liability related to decommissioning, restoration, or similar liabilities in other comprehensive income, increasing or decreasing the revaluation surplus and carrying amount of the revalued asset. Refer to International Financial Reporting Interpretations Committee 5, *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, for guidance on accounting for changes in these liabilities.

Income Taxes

5.27 The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. Therefore, initial and subsequent revaluations of revalued assets may have income tax implications that an entity reflects in its financial statements. An entity recognizes and discloses information about income tax effects in accordance with IAS 12, *Income Taxes*. Subject to the conditions discussed previously with respect to recognition of increases and decreases of revalued assets, when an entity recognizes the change in revaluated amount in other comprehensive income, it also recognizes the tax effect in other comprehensive income. The resulting change to the revaluation surplus is the after-tax amount of the change. Also refer to chapter 10, "Income Taxes," of this book for additional information regarding accounting for income taxes.

Treatment of Accumulated Depreciation at Revaluation

5.28 At the date of the revaluation, an entity treats the accumulated depreciation for the revalued asset in one of following ways:

- Restate the accumulated depreciation account proportionally with the change in the gross carrying amount of the asset from revaluation so that the net of the gross carrying amount of the revalued asset and its associated accumulated depreciation account equals its revalued amount.
- Eliminate the accumulated depreciation against the gross carrying amount of the asset before revaluation and then restate the net asset to revalued amount.

Depreciation

5.29 Paragraph 43 of IAS 16 requires an entity to allocate the depreciable amount of an item of PP&E on a systematic basis over its estimated useful life. The depreciable amount of an item of PP&E is its cost less an estimated residual value. An entity should select a depreciation method that reflects the pattern in which an entity expects to consume the economic benefits of the assets.

5.30 IAS 16 requires the entity to depreciate separately each part (component) of an item of PP&E with a cost that is significant in relation to the total cost of the item. An entity recognizes depreciation in profit or loss except to the extent that IFRSs permit the entity to capitalize depreciation as part of the cost of another asset.

5.31 IAS 16 permits a variety of depreciation methods which include the following:

- Straight line
- Declining balance and other accelerated methods
- Units of production

Treatment of Changes in Depreciation Method, Useful Life, and Residual Value

5.32 In accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity treats a change in deprecation method as a change in accounting estimate and it is accounted for prospectively.

5.33 IAS 16 requires an entity to review annually its estimates of useful life and residual value. As previously noted, the entity determines depreciable amount after deducting residual value from the cost capitalized on initial recognition of the asset. If the entity's expectations differ from previous estimates of useful life and residual value, the entity accounts for the change as a change in accounting estimate.

5.34 *Residual value* is defined as the estimated amount that an entity would obtain currently from disposal of the asset, after deducting estimated costs of disposal, assuming the asset is already of the age and condition expected at the end of its useful life. To the extent residual value is volatile, depreciation expense will also be volatile. However, in practice, an entity's estimate of residual value is often immaterial and does not play a major role in the depreciation calculation process.

5.35 The following is an example of component depreciation.

An airline purchases a new aircraft and identifies the following significant parts:

- Fuselages
- Engines
- Electrical system
- Interior cabin (for example, seats, overhead compartments, and so on)
- Major inspection and overhaul costs for the engines

At purchase, the airline allocates the purchase price to each of these significant parts and estimates useful lives and residual values for each. For example, the airline estimated that the useful life of the major inspection and overhaul costs was 2,000 hours of running time. It estimated a residual value of zero because it would not be permitted by law to fly the plane for more than 2,000 hours. In contrast, the airline estimated the useful life of the interior cabin to be 5 years, also with a residual value of zero, based on its experience of how long it takes before the interior cabin becomes too worn and dirty for its passengers. The airline also made useful life and residual value estimates of the other parts it identified. Therefore, even if the airline used the straight-line method to depreciate these assets, the amount of depreciation expense recorded each reporting period would be different from the amount it would have recorded if it had depreciated the aircraft as a whole.

Derecognition

5.36 On disposal of an item of PP&E or when no future economic benefits are expected from its use or disposal, the entity derecognizes the carrying amount of an item of PP&E, in accordance with paragraph 67 of IAS 16.

5.37 When an entity derecognizes an item of PP&E, it recognizes any resulting gain or loss in profit and loss. An entity should not classify gains as revenue because a disposal of an item of PP&E is not part of the entity's major operating activities.

5.38 In accordance with paragraph 41 of IAS I6, in regard to disposal and derecognition of a revalued asset, the entity transfers any revaluation surplus included in equity in respect of that asset directly to retained earnings.

Disclosure

5.39 An entity should make the disclosures listed in paragraphs 73–77 of IAS 16 for each class of PP&E. These disclosures include the following:

- Measurement bases used for determining gross carrying amounts
- Depreciation methods, useful lives, or depreciation rates used by entity
- Gross carrying amount and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of each period
- A reconciliation (often referred to as a roll-forward) of the carrying amount at the beginning and end of each period for each asset class, disclosing the following:
  - Additions
  - Assets classified as held for sale or included in a disposal group classified as held for sale (in accordance with the guidance found in IFRS 5)
  - Acquisition through business combinations
  - Impairment losses recognized or reversed in profit or loss
  - Depreciation
  - The net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity
  - Other changes

5.40 The entity should also disclose the following:

- The existence and amounts of restrictions on title and PP&E pledged as security for liabilities
- The amount of expenditures recognized in the carrying amount for assets that are in a course of its construction
- The amount of contractual commitments for the acquisition of PP&E
- The amount of compensation from third parties for PP&E that were impaired, lost, or given up as it is included in profit or loss, if it is not separately disclosed in the statement of profit or loss and other comprehensive income

5.41 For PP&E stated at revalued amounts, the entity should make the following additional disclosures:

- Effective date of the revaluation
- Whether an independent valuation was performed
- The carrying amount that would have been recognized has the assets been carried under the cost model for each class of PP&E that was revalued
- Revaluation surplus with the change for the period and any restriction on the distribution of the balance to shareholders
- Increases or decreases resulting from revaluations and impairment losses recognized or reversed in accordance with IAS 36

5.42 In accordance with IAS 8, the entity should also disclose the nature and effect of a change in an accounting estimate for PP&E that has an effect in the current period or is expected to have an effect in subsequent periods. Changes that may affect current and future period balance sheets and profit or loss include estimates of residual values; estimated costs of dismantling, removing, or restoring items; useful lives; and depreciation methods.

5.43 IAS 16 encourages an entity to disclose the following information because it may be useful to the users of financial statements:

- The gross carrying amount of any fully depreciated PP&E still in use
- When the cost model is used, the fair value of PP&E when it is materially different from the carrying amount
- The carrying amount of the following items of PP&E not in use:
  - Temporarily idle PP&E
  - PP&E retired from active use and not classified as held for sale in accordance with IFRS 5

Chapter 6

Impairment of Assets

Overview

6.01 This chapter prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. When the carrying amount of an asset exceeds its recoverable amount, an entity considers that asset impaired and should recognize an impairment loss to restate the carrying value to recoverable amount. This chapter also explains when an entity should reverse an impairment loss previously recognized and the disclosures required when the entity recognizes impairment losses or reversals.

Summary of Selective Accounting Guidance

6.02 The primary accounting literature relating to the impairment of assets is International Accounting Standard (IAS) 36, *Impairment of Assets*, unless another standard or requirement permits or requires a different accounting treatment.

Scope and Scope Exceptions

6.03 The accounting described in this chapter and IAS 36 applies to the impairment of all assets except the following:

- Inventories within the scope of IAS 2, *Inventories*
- Assets arising from the following:
  - Construction contracts within the scope of IAS 11, *Construction Contracts*
  - Employee benefits within the scope of IAS 19, *Employee Benefits*
  - Insurer's contractual rights under insurance contracts, such as deferred acquisition costs and intangible assets, within the scope of International Financial Reporting Standards (IFRS 4), *Insurance Contracts*[1]
- Assets measured at fair value or fair value less costs of disposal:
  - Investment property within the scope of IAS 40, *Investment Property*
  - Biological assets related to agricultural activity with the scope of IAS 41, *Agriculture*[2]
- Deferred tax assets within the scope of IAS 12, *Income Taxes*
- Noncurrent assets or disposal groups classified as held for sale within the scope of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*
- Financial assets within the scope of IAS 39, *Financial Instruments: Recognition and Measurement* (or IFRS 9,[3] *Financial Instruments*, when effective)

6.04 However, this chapter and IAS 36 do apply to the following financial assets:

- Subsidiaries, as defined in IFRS 10, *Consolidated Financial Statements*
- Associates, as defined in IAS 28, *Investments in Associates*
- Joint ventures, as defined in IFRS 11, *Joint Arrangements*

Refer to chapter 29, "Consolidated and Separate Financial Statements," of this book for a detailed discussion of the requirements of IFRS 10, and chapter 8, "Investments in Associates and Joint Arrangements," for additional guidance on IAS 28 and IFRS 11.

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[1] This topic is beyond the scope of this book.

[2] See footnote 1.

[3] International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, will be replaced with the requirements of International Financial Reporting Standard 9, *Financial Instruments*, upon its effective date, which is for annual periods beginning on or after January 1, 2015.

6.05 Assets measured at revalued amount in accordance with IAS 16, *Property, Plant and Equipment*, and IAS 38, *Intangible Assets*, are within the scope of this chapter and IAS 36.

Definitions

6.06 The following definitions are essential to applying the requirements of IAS 36.

cash generating unit (CGU). The smallest identifiable group of assets that generate cash flows that are largely independent of the cash flows generated by other assets or groups of assets.

costs of disposal. Sometimes referred to as costs to sell. The incremental costs directly attributable to the disposal of an asset or CGU, excluding interest and other finance costs and income tax expense.

fair value. The price that the entity would receive to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, in accordance with IFRS 13, *Fair Value Measurement*.

recoverable amount of an asset or CGU. The higher of its **fair value** less **costs of disposal** or its **value in use**.

value in use. The present value of the future cash flows expected that the entity expects to derive from an asset or CGU.

Overview of the Procedures for Testing and Measurement of Asset Impairments Under IAS 36

6.07 To meet the requirements of IAS 36, an entity applies the following procedures:

1. Identify assets that might be impaired (or recovered) by assessing whether there are any indicators of impairment (or recovery) at the end of the reporting period.
2. Test the asset for impairment (or recovery) by estimating its recoverable amount when an indicator of impairment exists.
3. Recognize and measure any impairment (or reversal of an impairment loss).

Identifying a Potentially Impaired or Recovered Asset

6.08 The first step to identify an asset with a carrying value that exceeds its recoverable amount is for the entity to assess whether any indicators of impairment exist at the end of the reporting period. When making this assessment, the entity should, at a minimum, consider both external and internal sources of information. External sources of information include, but are not limited to, the following:

- The entity observed that an asset's market value declined significantly more than the entity would expect it to decline during the period as a result of the passage of time or normal use.
- The entity observed during the period either significant changes in the technological, market, economic, or legal environment in which the entity operates, or in the market to which an asset is dedicated, and that may adversely affect it.
- The entity observed during the period an increase in market interest rates or other market rates of return on investments that are likely to affect the discount rate an entity used to calculate an asset's value in use and, therefore, would materially decrease the asset's recoverable amount.
- The entity's market capitalization is less than the carrying amount of the entity's net assets.

6.09 Internal sources of information include, but are not limited to, the following:

- The entity finds evidence that the asset is obsolete or is physically damaged.
- The entity finds that significant adverse changes have already occurred, or are expected to occur in the near future, and these changes will impact the extent or the manner in which the entity uses or expects to use an asset. For example, an asset

becomes idle, or the entity plans to discontinue or restructure the operation to which an asset belongs.

- The entity finds evidence from internal reporting that indicates that the asset's economic performance is, or will be, worse than expected.
- With respect to an investment in a subsidiary, associate, or joint venture from which the entity receives dividends, the entity finds evidence that
  - the carrying amount of the investment in the entity's separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
  - the dividend exceeds the total comprehensive income of the investment in the period the dividend is declared.

6.10 When an indicator or indicators of impairment exist for an asset, the entity tests the asset for impairment by measuring its recoverable amount. Except for the intangible assets with indefinite useful lives or not yet available for use or goodwill, an entity is not required to make a formal estimate of recoverable amount when no indicator of impairment exists.

Intangible Assets With Indefinite Useful Lives, Not Yet Available for Use, and Goodwill

6.11 The entity should test the following assets for impairment annually, even when no indicator of impairment exists:

- Intangible assets with indefinite useful lives
- Intangible assets that are not yet available for use
- Goodwill

Recognition and Measurement of Impairment Losses

Measuring an Asset's Recoverable Amount

6.12 When an indicator of impairment exists, IAS 36 requires the entity to make a formal estimate of recoverable amount, which is the higher of its fair value less costs of disposal and its value in use. However, if either fair value less costs of disposal or value in use exceeds the asset's carrying amount, the asset is not impaired and the entity need not calculate both amounts.

Determining an Asset's Fair Value Less Costs of Disposal

6.13 The entity applies the requirements of IFRS 13 to determine fair value. IFRS 13 defines *fair value* as a price in an orderly market transaction at the measurement date. Briefly, when a fair value measurement is for a particular asset, the entity should take into account the characteristics of the asset and use the assumptions that market participants would take into account or use when pricing the asset at the measurement date. IFRS 13 also requires the entity to assume the transaction would take place in the principal market for the asset or, if there is no principal market, in the asset's most advantageous market. For nonfinancial assets, IFRS 13 also requires the entity to value the asset at its highest and best use, which would provide maximum value to market participants. Refer to IFRS 13 for additional guidance on determining fair value.

6.14 The entity then deducts costs directly attributable to the disposal transaction from fair value. Such costs may include legal costs, stamp duty and similar transactions, removal costs, and direct incremental costs necessary to bring the asset into condition for sale. However, the entity should not deduct termination costs as defined in IAS 19, *Employee Benefits*, and costs to reduce or reorganize or reorganize a business after it disposes of the asset because they are not directly attributable to the disposal transaction.

6.15 IAS 36 recognizes that, even when there is no quoted price in an active market for identical assets, the entity may still be able to make a reliable estimate of fair value less costs of disposal using the guidance described in the previous paragraphs. However, sometimes there is no basis for determining fair value less costs of disposal. In that case, the entity uses value in use as the asset's recoverable amount.

Determining an Asset's Value in Use

6.16 The entity estimates the asset's value in use as follows:

a. Estimate the future cash flows as follows:

i. Cash inflows from continuing use of the asset.

ii. Cash outflows that it will necessarily incur to generate the above cash inflows, including those to get it ready for use, which it can directly attribute or allocate to the asset on a reasonable and consistent basis.

iii. Net cash flows, if any, that it will receive or pay to dispose of the asset at the end of its useful life.

b. Determine the current market risk-free interest rate to those future cash flows.

c. Make the following adjustments to either the estimated cash flows or the risk-free interest rate, but not both:

i. Expectations about possible variability in the amount or timing of these future cash flows.

ii. Risk of uncertainty inherent in the asset.

iii. Other factors, such as lack of liquidity, that market participants would incorporate in pricing the expected future cash flows the asset will generate.

d. Calculate value in use as the present value of the estimated cash flows and discount rate that result from the risk adjustment process.

Estimating Cash Flows

6.17 The entity should base its cash flow projections on the following:

- Reasonable and supportable assumptions, giving greater weight to external evidence. These assumptions should represent the entity's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset.
- Recent approved financial budgets and forecasts with the following constraints:
  - Include specific forecasts over a maximum of five years.
  - Exclude cash flows for restructurings to which the entity is not yet committed.
  - Exclude cash flows for future asset enhancements or improvements.
  - Extrapolate beyond the five-year period using a steady or declining growth rate, not exceeding the long-term growth rate for the products, industries, country or countries in which the entity operates.

IAS 36 permits the entity to deviate from these constraints on the budget and forecast period and growth rate only if the entity can justify a longer period or higher rate, respectively.

6.18 Subject to the constraint that the entity can either directly attribute or allocate cash flows on a reasonable and consistent basis, the entity should include in the cash flow projections expenditures for day-to-day servicing of the asset and future overheads. When the asset is not yet ready for use, the entity also includes estimates of additional expenditures necessary to get the asset ready for use or sale. However, cash flow projections do not include cash flows from assets that are largely independent from the cash flows of the asset under review or cash flows relating to recognized liabilities. The entity should not include cash inflows or outflows from financing activities or income tax in these projections.

6.19 The entity estimates the net cash flows that the entity will receive or pay at the asset's disposal in a manner similar to determining fair value, except that

- the entity should use prices prevailing at the date of the estimate for similar assets that have both
  - reached the end of their useful lives; and
  - operated under similar conditions to those that will affect the use of the asset under consideration.
- the entity should adjust those prices for the effect of future prices increases due to general inflation and specific future price increases or decreases, unless both the discount rate and estimates of cash flows from continuing use of the asset exclude inflation adjustments.

6.20 An entity only includes cash flows for restructurings to which it is committed in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Because a restructuring materially changes the scope of a business that the entity has undertaken or the manner in which it conducts a business, when the entity is committed to such a restructuring, it should

- reflect the cost savings and other benefits from the restructuring in the estimate of future cash inflows and outflows used in determining value in use, subject to the constraint that these are included in the most recent financial budgets or forecasts approved by management; and
- include a restructuring provision with its estimates of future cash outflows for the restructuring in accordance with IAS 37.

Example 5 of the illustrative examples that accompany IAS 36 shows how to incorporate cash flows of a future restricting in the value in use calculation.

Discount Rate

6.21 The entity uses a pretax discount rate or rates that incorporate current market assessments of the following:

- Time value of money (risk-free interest rate)
- Risks specific to the asset for which the entity has not adjusted the future cash flow estimates

6.22 The entity should estimate the discount rate, starting with the rate implicit in current market transactions for similar assets or from a weighted average cost of capital of a listed entity that has a single asset or portfolio of assets that is similar in terms of service potential and risks to the asset under review.

6.23 When the entity cannot determine an asset-specific discount rate from market transactions, it should use surrogates to estimate the discount rate. As described in appendix A to IAS 36, the entity could start with its weighted average cost of capital, incremental borrowing rate, or another market borrowing rate. However, it should use a discount rate that is independent of its capital structure and the way it financed the asset's acquisition. The asset's future cash flows are independent of these decisions. Therefore, the entity should adjust this rate to reflect the way in which the market would assess the risks specific to the estimated cash flows of the asset under review and exclude risks that are not relevant to these cash flows or that have already been incorporated in the cash flow estimates. Risks that entity should consider include country risk, currency risk, and price risk.

6.24 The entity normally uses a single discount rate to estimate value in use. However, when value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates, the entity uses separate discount rates for these different future periods. Refer to appendix A of IAS 36 for additional guidance on determining the discount rate.

Foreign Currency Cash Flows and Discount Rate

6.25 An entity estimates future cash flows in the currency in which they will be generated. The entity uses a discount rate appropriate for that currency to calculate the present value of the expected future cash flows and then translates the present value using the spot exchange rate at the date of the value in use calculation.

Recognizing and Measuring an Impairment Loss on Assets Other Than Goodwill

6.26 When an asset's recoverable amount is less than its carrying value, the entity should recognize an impairment loss and reduce the asset's carrying value to recoverable amount. The entity recognizes an impairment loss immediately in profit or loss, unless the asset is carried at revalued amount in accordance with IAS 16 or IAS 38. The entity treats impairment losses on assets carried at revalue amount as revaluation decreases in accordance with the applicable standard. Refer to the guidance in chapter 5, "Property, Plant, and Equipment," or chapter 4, "Intangible Assets," in this book or IAS 16 or IAS 38, respectively.

6.27 When the amount of an impairment loss exceeds the asset's carrying value, an entity should only recognize a liability when recognition is required by another standard.

6.28 After the entity recognizes an impairment loss, it should also adjust the depreciation or amortization of the asset in future periods to allocate the revised carrying value, less its residual value, if any, on a systematic basis over the asset's remaining useful life. At the same time, the entity should review the reliability of its estimates of residual value and useful life. In accordance with the guidance in IAS 12, the entity should also adjust any deferred tax assets or liabilities associated with the asset by comparing its revised carrying value to its tax base.

Reversing an Asset's Impairment Loss

6.29 As part of its assessment of indicators of impairment, an entity should also assess whether there are indicators that an asset's recoverable amount has increased. If so, the entity may need to recognize a reversal of the impairment loss. The procedures for identifying whether the entity should reverse an impairment loss mirror those it followed in testing and measuring the asset for impairment. First, the entity identifies assets whose recoverable amount may have increased. The entity then measures the asset's recoverable amount and compares it to the asset's current carrying value. Finally, if recoverable amount exceeds the asset's carrying value, the entity determines whether it recognizes a reversal of an impairment loss.

6.30 When an entity determines that the recoverable amount of a previously impaired individual asset other than goodwill is greater than its carrying amount, it should recognize a reversal of the impairment loss subject to the constraint that the revised carrying amount should not exceed the carrying amount, net of the deprecation or amortization, that would have resulted had the entity not previously recognized an impairment loss.

6.31 Unless the entity carries the asset at revalued amount, the entity recognizes the reversal immediately in profit or loss. When the asset is carried at revalued amount, the entity treats any increase above the current carrying value as a revaluation increase, accounted for in accordance with the IAS 16 for property, plant, and equipment (PP&E), or IAS 38 for intangible assets. The entity may also need to adjust any deferred tax assets or liabilities related to this asset in accordance with IAS 12.

6.32 The entity also adjusts the depreciation or amortization on the asset in future periods, as described previously in paragraph 6.28. At the same time, the entity should also review its estimates of the asset's useful life and residual value.

Intangible Assets With an Indefinite Useful Life

6.33 IAS 36 requires an entity to formally determine the recoverable amount of an intangible asset with an indefinite useful life annually and test the asset for impairment, comparing its carrying amount to its recoverable amount even when no indicator of impairment exists. To test this asset for impairment, an entity may use the most recent detailed calculation of the asset's recoverable amount provided all of the following criteria are met:

- The most recent calculation of the intangible asset's recoverable amount exceeds its carrying amount by a substantial margin.
- The likelihood is remote that a new calculation of its current recoverable amount would be less than the asset's carrying amount, based on the entity's analysis of events that

have occurred and circumstances that have changed since the most recent recoverable amount calculation.

6.34 If the intangible asset does not generate cash inflows from continuing use that are largely independent from other assets or groups of assets, the entity should determine the intangible asset's recoverable amount by using the CGU to which the asset belongs. In this case, the entity may use its most recent detailed calculation of the asset's recoverable amount, provided the recoverable amount exceeded the CGU's carrying value by a substantial margin and the assets and liabilities in that CGU have not significantly changed since the most recent calculation of the intangible asset's recoverable amount.

Cash Generating Units

6.35 The following paragraphs provide requirements for identifying the CGU to which an asset belongs, determining their carrying amount, and recognizing impairment losses for CGUs and goodwill. Refer to appendix C of IAS 36 for additional guidance regarding testing for impairment those CGUs with allocated goodwill and noncontrolling interests.

Assets With Cash Flows Dependent Upon Other Assets or Groups of Assets

6.36 When an asset does not generate cash inflows that are largely independent from other assets or groups of assets, the entity determines the asset's recoverable amount by using the CGU to which the asset belongs, unless the asset's fair value less costs of disposal

- is higher than the asset's carrying amount; or
- can be determined and the estimate of value in use is close to its fair value less costs of disposal.

6.37 An entity may use reasonable approximations of the detailed computations for determining an asset's fair value less costs of disposal or its value in use. These approximations may include estimates, averages, and computational short cuts.

6.38 However, if the entity cannot determine the asset's recoverable amount as described in the previous paragraphs, the entity can only determine recoverable amount for the CGU and should identify the CGU to which the asset belongs.

Identifying the CGU to Which an Asset Belongs

6.39 As defined in IAS 36, a CGU is the smallest group of assets that includes the asset under consideration and generates cash flows that are largely independent from the cash flows of other assets. Determining an asset's CGU requires the entity to use judgment in identifying this lowest aggregation of assets that meets this definition. The entity should consider the following various factors when identifying whether cash inflows from an asset or group of assets are largely independent of the cash inflows from other assets or groups of other assets. Some factors to be considered include the following:

- How the entity monitors its operations (for example, by product lines, businesses, individual locations, districts, or regional areas)
- How the entity makes decisions about continuing or disposing of assets and operations

Refer to the illustrative examples that accompany IAS 36 for examples related to identifying an asset's CGU.

6.40 However, when an active market exists for their output, the entity should identify that asset or group of assets to be a CGU, even if it uses some or all of the output internally. When internal transfer pricing affects the cash inflows generated by an asset or CGU, management should use its best estimate of future prices that could be achieved in arm's length transactions when estimating the following future cash flows:

- Inflows used to determine the asset's or CGU's value in use
- Outflows used to determine the value in use of any other assets or CGUs that are affected by the internal transfer pricing

6.41 Other units of an entity sometimes use all or part of the output produced by an asset or a group of assets. For example, different units may be responsible for different aspects of a production process and the output from one unit becomes the input to another unit. However, when one of these intermediate products can be sold in an active market, the asset or group of assets that creates that intermediate product could generate cash inflows largely independent of the cash inflows from other assets or groups of assets. Consequently, the entity should consider the asset or groups of asset that create the intermediate product a separate CGU. In determining the appropriate cash flow to include in calculating recoverable amount, the entity should adjust the information based on financial budgets or forecasts that relate to the CGU, or to any other asset or CGU that incorporates internal transfer prices when those prices do not reflect management's best estimate of future prices in that external market.

6.42 An entity should identify its CGUs consistently, from period to period, for the same asset or types of assets. An entity should justify any changes in its CGUs that occur. When an entity's management determines that an asset belongs to a different CGU than that in previous periods, or that the types of assets aggregated in a CGU have changed and it recognized or reversed an impairment loss on an asset in that CGU, IAS 36 requires specific disclosures about that CGU.

Recoverable Amount and Carrying Amount of a CGU

6.43 Similar to recoverable amount for an individual asset, a CGU's recoverable amount is the higher of the CGU's fair value less costs of disposal and its value in use. The entity determines a CGU's carrying amount on a basis consistent with the way in which it determines the CGU's recoverable amount. The prior guidance in this chapter for determining the recoverable amount of an individual asset applies equally to determining the recoverable amount of a CGU.

6.44 An entity determines a CGU's carrying value as follows:

- Include only the carrying amounts of those assets that can be directly attributed or allocated, on a reasonable and consistent basis, to the CGU, and will generate future cash inflows that an entity should use when determining the CGU's value in use.
- Exclude the carrying amount of any recognized liability, unless the CGU's recoverable amount cannot be determined without the consideration of the recognized liability.

6.45 When grouping assets for recoverability, the entity should include all assets that generate or are used to generate the relevant stream of cash inflows. If some assets are excluded, the CGU may appear to be recoverable when an impairment loss has occurred. However, the entity may not be able to allocate on a reasonable or consistent basis some assets that contribute to the estimated future cash flows of a CGU. This may be the case for goodwill or corporate assets, including headquarters' assets. For additional guidance on these issues, refer to the "Allocating Goodwill to CGUs" and "Corporate Assets" sections in this chapter.

Recognized Liabilities

6.46 An entity does not normally include recognized liabilities when determining a CGU's recoverable amount. However, when disposal of a CGU would require the buyer to assume a recognized liability, the entity may need to include that liability when determining a CGU's recoverable amount because it cannot otherwise perform a meaningful comparison of fair value less costs of disposal and value in use. In these circumstances, the entity deducts the liability when determining both the CGU's carrying value and its value in use.

6.47 Practicality sometimes requires the entity to determine a CGU's recoverable amount taking into consideration assets that are not part of the CGU or recognized liabilities. In these circumstances, the entity increases the CGU's carrying value by those assets' carrying values and decreases the CGU's carrying value by the carrying values of the recognized liabilities. Examples of such assets and liabilities include receivables or other financial assets, payables, pensions, and other provisions.

6.48 The following is an example on including a recognized liability in a CGU's carrying value and recoverable amount.

Example 6-1

Facts

- A manufacturer operates a plant that releases hazardous waste into the plant site.
- The plant site is located in a country where legislation requires that the site be restored before it is leased or sold.
- The manufacturer recognized a liability for the costs to restore the plant site. The manufacturer also included these costs as part of the cost of the plant and depreciates these costs over the plant's estimated useful life.
- The carrying value of the liability for the cost of the restoration is currency unit (CU) 1,000, which is equal to the present value of these costs.
- The manufacturer is testing the plant for impairment and identifies the plant, as a whole, as a CGU.
- The manufacturer has received several offers to buy the plant site. All offers are close to a price of CU 1,600, which reflects the fact that the buyer would assume the obligation to restore the plant site.
- The disposal costs for the plant site are negligible.
- The value in use of the plant site is approximately CU 2,400, excluding restoration costs.
- The carrying amount of the plant site is CU 2,000.

Analysis

Fair value was determined based on existing offers to buy the plant. Because the buyers would include the requirement to assume the restoration liability in their calculation of an offer price, the entity would also include the recognized liability in its calculation of recoverable amount and carrying value.

Fair value	CU 1,600
Costs of disposal	0
Fair value less costs of disposal (A)	CU 1,600
Value in use—assets only	CU 2,400
Restoration liability	(1,000)
Value in use (B)	CU 1,400
Recoverable amount (higher of [A] and [B])	CU 1,600
Carrying value—assets only	CU 2,000
Restoration liability	(1,000)
Net carrying value	CU 1,000
Compare carrying value to recoverable amount:	
Net carrying value	CU 2,000
Less: Recoverable amount	(1,600)
Impairment loss	CU 400

Therefore, the manufacturer will recognize an impairment loss of CU 400 on the plant in profit or loss.

Goodwill

Allocating Goodwill to CGUs

6.49 Goodwill recognized in a business combination is an asset representing future economic benefits arising from other assets acquired in the combination that the entity has not individually identified and recognized separately. Because the assets represented by goodwill cannot be identified separately, goodwill is an asset that does not generate cash flows that are largely independent of the cash flows of other assets or groups of assets. Goodwill often contributes to multiple CGUs. Therefore, IAS 36 requires an entity to allocate goodwill to CGUs that the entity expects to benefit from the synergies of the business combination.

6.50 The entity sometimes only can allocate goodwill to individual CGUs arbitrarily and needs to aggregate CGUs into groups in order to arrive at a reasonable allocation process. Therefore, the entity should allocate goodwill to CGUs in the same way it monitors goodwill for internal management purposes. The way in which an entity manages its operations and the manner with which goodwill would naturally be associated is the level at which goodwill is tested for impairment. Therefore, there is typically no need for an entity to develop additional reporting systems. However, IAS 36 does not permit the entity to allocate goodwill to a CGU larger than an operating segment, as defined in IFRS 8, *Operating Segments.* Refer to IAS 36 and appendix C in IAS 36 for additional guidance on this issue.

6.51 The entity may allocate goodwill to a lower level for purposes of measuring foreign currency gains and losses in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, than it allocates goodwill for impairment testing, unless the entity monitors goodwill for internal management purposes at the same level.

6.52 Sometimes the entity cannot complete the accounting for the business combination before the end of the reporting period. In these circumstances, IFRS 3, *Business Combinations*, requires the entity to record provisional amounts and permits the entity to take up to 12 months after the acquisition date to finalize the accounting. When this occurs, the entity may also not be able to allocate goodwill before the end of the accounting period. IAS 36 requires the entity to complete its initial allocation of goodwill before the end of the first annual period beginning after the acquisition date.

Derecognition of Operations Included in a CGU With Allocated Goodwill

6.53 When an entity disposes of an operation included in a CGU with allocated goodwill, the entity treats the goodwill associated with the disposed operation as follows:

- Include this goodwill when determining the carrying amount the entity uses to calculate the gain or loss on the disposal of the operation
- Measure this goodwill on the basis of the relative values of the operation disposed of and the retained portion of the CGU, unless the entity can demonstrate the method it uses better reflects the goodwill associated with the disposed operation

6.54 The following is an example of how a manufacturer would determine the goodwill to be derecognized on the sale one of its plant operations that was part of a CGU to which goodwill had been allocated.

Example 6-2

Facts

- A manufacturer sells its northeastern plant operations for CU 400.
- The northeastern plant operation was part of a CGU to which CU 1,000 of goodwill had been allocated.
- The goodwill allocated to the plant operations cannot be identified or associated with an asset group at a level lower than that CGU.
- The recoverable amount of the portion of the CGU retained is CU 1,200.

Analysis

Based upon the previous fact pattern, the goodwill allocated to the CGU could only be arbitrarily identified or associated with an asset group at a level lower than the CGU.

Therefore, the goodwill associated with the northeastern plant operation being sold was measured on the basis of the relative values of the northeastern plant operation sold and the portion of the CGU retained.

Fair value less costs to dispose of the plant operations	CU 400
Recoverable amount of the CGU retained	1,200
Total value of the CGU	CU 1,600
Goodwill allocated to the CGU	CU 1,000
Proportion of CGU value: Plant operations (400/1,600)	× 0.25
Goodwill allocated to plant operations	CU 250

Therefore, when determining the gain or loss on the sale of the plant operations, the manufacturer should include CU 250 of the goodwill allocated to the CGU in the plant operation's carrying value.

Changes in CGUs With Allocated Goodwill as a Result of Reorganization or Restructuring

6.55 When an entity reorganizes its reporting structure, the composition of a CGU(s) with allocated goodwill may also change. Unless the entity can demonstrate that some other allocation method better reflects the goodwill associated with the reorganized CGUs, the entity should reallocate goodwill to the CGUs affected using the relative value approach. This approach is similar to the approach used when an entity disposes of an operation that is part of a CGU, described previously in paragraph 6.53.

6.56 The following is an example of a manufacturer that reorganized its reporting structure so that one CGU was eliminated and its assets and operations integrated into three other CGUs. Consequently, the manufacturer was required to reallocate the goodwill that was allocated originally to the eliminated CGU.

Example 6-3

Facts

- The manufacturer previously allocated CU 900 of goodwill to CGU A.
- The entity cannot identify or associate the goodwill allocated to CGU A to an asset group at a level lower than CGU A, except arbitrarily.
- The manufacturer reorganized its reporting structure, integrating the assets and operations of CGU A into three other CGUs: B, C, and D. The recoverable amounts of these CGUs are as follows:
  - CGU B: CU 1,500
  - CGU C: CU 1,800
  - CGU D: CU 2,700

Analysis

The goodwill allocated to the CGU A cannot be identified or associated with an asset group at a level lower than CGU A. Therefore, the entity reallocates the goodwill allocated to CGU A using the relative value approach because any other method would be arbitrary. The relative values of the three portions of CGU A before those portions are integrated with CGU B, CGU C, and CGU D as follows:

CGU	*Recoverable Amount*	*Relative Value*	*Reallocation of CU 900 Goodwill of CGU A*
B	CU 1,500	0.35	CU 225
C	1,800	0.30	405
D	2,700	0.45	270
Total	CU 6,000		

Testing CGUs With Goodwill for Impairment

6.57 When goodwill is associated with a CGU, but the entity has not allocated goodwill to that CGU, the entity tests that CGU for impairment whenever there is an indicator that the CGU may be impaired. The entity compares the CGU's recoverable amount to its carrying amount, excluding any goodwill. If the CGU's recoverable amount is less than its carrying amount, the entity will recognize an impairment loss in accordance with paragraph 6.26 of this chapter.

6.58 An entity should test a CGU for impairment annually whenever that CGU includes an intangible asset that has both of the following characteristics:

- The intangible asset has an indefinite useful life or is not yet available for use.
- The intangible asset can only be tested for impairment as part of the CGU.

6.59 An entity should annually test for impairment a CGU with allocated goodwill or more often if there is an indicator that the CGU is impaired. If the CGU's recoverable amount is greater than its carrying value (including goodwill), the entity should not allocate an impairment loss to that CGU or its allocated goodwill. If the CGU's recoverable amount is less than its carrying value (including goodwill), the entity recognizes an impairment loss in accordance with paragraph 6.26.

Timing of Impairment Tests

6.60 An entity may test a CGU with allocated goodwill annually for impairment at any time during the year and different CGUs at different times during the year, as long as the entity performs the test on a particular CGU at the same time every year. However, if some or all of the goodwill allocated to a CGU is acquired in a business combination, the entity should test that CGU for impairment before the end of the current annual period.

6.61 Whenever there is an indicator that an individual asset is impaired, an entity should always test that asset for impairment first, before including that asset in a CGU and testing the CGU for impairment. Similarly, when there is an indicator that a CGU within a group of CGUs is impaired, the entity should test the individual CGU or smaller group of CGUs first before testing a group of CGUs or larger group of CGUs, respectively.

6.62 IAS 36 permits an entity to carry forward the most recent detailed calculations made in a preceding period and used in that period for the impairment test on a CGU with allocated goodwill when all of the following criteria are met:

- There has been no significant change in the assets and liabilities making up the CGU since the most recent calculations of the recoverable amount.
- The recoverable amount resulting from the most recent calculation exceeds the carrying amount of the CGU by a substantial margin.
- There is a remote likelihood that a current recoverable amount, based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, would be less than the current carrying amount of the CGU.

6.63 These criteria are essentially the same as the criteria the entity would need to meet to use calculations from a previous period in the current period's impairment test for an individual asset. Refer to appendix C of IAS 36 for additional guidance regarding the allocation of goodwill to a CGU(s).

Corporate Assets

6.64 IAS 36 defines *corporate assets* to be assets, other than goodwill, that contribute to the future cash flows of both the CGU under review and other CGUs. An entity's structure should determine whether an asset meets the definition of a corporate asset. Corporate assets include a group or divisional assets, such as the group's or division's headquarters, electronic data processing equipment, or a research center. Corporate assets have the following distinctive characteristics:

- They do not generate separate cash inflows independently of other assets or groups of assets.
- The entity cannot fully attribute their carrying amounts to the CGU under review.

6.65 Because a corporate asset does not independently generate its own separate cash inflows, unless an entity decides to dispose of the corporate asset, it cannot determine that asset's recoverable amount. When there is an indication that a corporate asset may be impaired, an entity should determine the corporate asset's recoverable amount by determining the recoverable amount for the CGU (or group of CGUs) to which the corporate asset belongs. The entity then compares this recoverable amount to the CGU's carrying value. The entity recognizes an impairment loss, if any, in accordance with paragraph 6.26.

6.66 An entity should identify all the corporate assets that relate to a CGU being tested for impairment. If the entity can allocate a portion of the carrying value of the corporate asset on a reasonable and consistent basis to the CGU, it should compare the CGU's carrying value, including the corporate asset allocation, to its recoverable amount. The entity recognizes any impairment loss in accordance with paragraph 6.26.

6.67 When an entity tests a CGU for impairment and has identified corporate assets that relate to that CGU, but cannot allocate the corporate asset on a reasonable and consistent basis to that CGU, the entity should

- compare the CGU's carrying value, excluding the corporate asset, with the CGU's recoverable amount and recognize any impairment loss in accordance with paragraph 6.26;
- allocate the carrying value of the corporate asset on a reasonable and consistent basis to the smallest group of CGUs that it can identify that includes the CGU under review; and
- compare the carrying amount of that group of CGUs, including the allocated carrying value of the corporate asset, with the CGUs' recoverable amount and recognize any impairment loss in accordance with paragraph 6.26.

Refer to example 8 of the illustrative examples in IAS 36 for an example of an allocation of corporate assets to a CGU.

Impairment Loss for a CGU

6.68 An entity should allocate any impairment loss on a CGU (or group of CGUs) by reducing the carrying values of the CGU's (or CGUs') assets using the following allocation procedures for a CGU:

1. First, reduce the carrying value of any goodwill allocated to the CGU.
2. Allocate any remaining impairment loss, after reducing goodwill to zero, to the other CGU assets pro rata based on the relative carrying values of the asset in the CGU.

6.69 In accordance with paragraph 6.26, the entity recognizes a reduction in the carrying value of an asset as an impairment loss on that individual asset. However, the entity does not reduce the carrying amount of an asset, to which it allocated an impairment loss, below the highest of the following amounts:

- The asset's fair value less costs of disposal, if measurable
- The asset's value in use, if determinable
- Zero

6.70 Based upon the previous allocation process, if the entity cannot allocate all of an impairment loss that would otherwise have been allocated to an asset, it should allocate the remaining amount on a pro rata basis to the other assets of the CGU or CGUs.

6.71 When it is impracticable for an entity to estimate the recoverable amount of each individual asset of a CGU, IAS 36 requires that the entity arbitrarily allocate the impairment loss among the assets of the CGU, other than goodwill, because all the assets work together to generate the CGU's cash flows.

6.72 When an entity cannot determine an individual asset's recoverable amount, then either

- the entity recognizes an impairment loss in accordance with paragraph 6.26 for the asset if its carrying value is greater than the higher of its fair value less costs of disposal and the resulting amount after the entity applies the allocation procedures for CGUs described; or
- the entity does not recognize an impairment loss for the asset if the related CGU is not impaired, even when the asset's fair value less costs of disposal is less than its carrying value.

6.73 After an entity has applied the described allocation procedures for a CGU or group of CGUs, the entity only recognizes a liability for any remaining impairment loss if required by another IFRS.

6.74 Refer to the example following paragraph 105 in IAS 36 for a description of how a manufacturer would account for an impairment loss for a CGU under the following assumptions:

- Management has not made a commitment to replace a damaged machine.
- Management has made a commitment to replace a damaged machine and sell it in the near future.

Reversing an Impairment Loss for Goodwill

6.75 An entity should not reverse a recognized impairment loss for goodwill in a subsequent period. IAS 38 prohibits the recognition of internally generated goodwill. When the recoverable amount of a CGU with allocated goodwill increases subsequent to the period in which the entity recognized an impairment loss for that goodwill, any increase that the entity cannot allocate to individual assets included in the CGU is not generally considered a reversal of that impairment loss, but rather an increase in internally generated goodwill.

Reversing an Impairment Loss for a CGU

6.76 When an entity determines that it should recognize a reversal of an impairment loss for a CGU, it allocates the amount of the reversal to the CGU's assets pro rata with the carrying value of those assets, not including goodwill, for the reason described in the previous paragraph. The entity recognizes the reversal immediately in profit or loss and increases the carrying values of individual assets, unless the individual asset is carried at revalued amount in accordance with IAS 16 or IAS 38. To the extent that the entity allocates a reversal to a revalued asset, it recognizes a revaluation increase in accordance with that relevant IFRS.

6.77 When the entity allocates the amount of the reversal of the CGU's impairment loss pro rata with the carrying values of the CGU's assets, except for goodwill, the entity should not increase the carrying value of an individual asset above the lower of the asset's

- recoverable amount, if determinable; or
- carrying value, net of deprecation or amortization, that the entity would have determined had no impairment loss been recognized for the asset in prior periods.

Disclosure

6.78 An entity should disclose the following amounts for each class of assets:

- Impairment losses recognized in profit or loss during the period and the line item(s) of the statement of profit or loss and other comprehensive income in which those impairment losses are included
- Reversals of impairment losses recognized in profit or loss during the period and the line item(s) of the statement of profit or loss and other comprehensive income in which those reversals are included
- Impairment losses on revalued assets recognized in other comprehensive income during the period
- Reversals of impairment losses on revalued assets recognized in other comprehensive income during the period

6.79 An entity that is required or elects to provide segment information in accordance with IFRS 8 should also provide these amounts by reportable segment.

6.80 An entity may present these amounts with other information disclosed for the classes of assets. For example, an entity would normally include information about impairment losses and reversals for classes of PP&E in the reconciliation of the carrying values at the beginning and end of the period of the accumulated depreciation and impairments account, in accordance with IAS 16.

6.81 For each material impairment loss recognized or reversed during the period for an individual asset, including goodwill, or a CGU, an entity should disclose the following:

- The events and circumstances that led to recognition or reversal of the impairment loss
- The amount of the impairment loss recognized or reversed

6.82 In addition, the entity should disclose the following:

- For an individual asset:
  - The nature of that asset.
  - If the entity reports segment information in accordance with IFRS 8, the reportable segment that includes the individual asset.
- For a CGU:
  - A description of the CGU, such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in IFRS 8.
  - The amount of the impairment loss recognized or reversed by class of assets.
  - If the entity changed the aggregation of assets for identifying the CGU since the entity's previous estimate, if any, of the CGU's recoverable amount, it should provide a description of the current and former basis for aggregating assets and the reasons it changed the way it identifies the CGU.
- Whether the recoverable amount of an asset or CGU is its fair value less costs of disposal or its value in use.
  - If recoverable amount is fair value less costs of disposal, the entity should describe the basis it used to determine fair value less costs of disposal; for example, whether it determined fair value by reference to an active market.
  - If recoverable amount is value in use, the entity should disclose the discount rate or rates it used to calculate present value for both its current and previous estimates, if any, of value in use.

6.83 The entity should disclose the following information about the aggregate of the impairment losses and the aggregate of the reversals that the entity recognized during the period for which it did not disclose the information required for individually material losses and reversals:

- Main classes of assets affected by impairment losses
- Main classes of assets affected by reversals of impairment losses
- Main events and circumstances that led to the recognition of the impairment losses or reversals, or both, of impairment losses

6.84 When an entity uses estimates to measure the recoverable amount of a CGU with allocated goodwill or a CGU that includes an intangible asset with an indefinite useful life, it is required to disclose the information about the estimates it used during the period to determine the recoverable amount of these CGUs. IAS 36 encourages entities not subject to this requirement to also disclose this information.

6.85 An entity should disclose the amount of any goodwill acquired in a business combination during the period that it has not yet allocated to a CGU or group of CGUs at the end of the reporting period.

Estimates Used to Measure the Recoverable Amount of CGUs With Allocated Goodwill

6.86 IAS 36 requires an entity to disclose additional information for each CGU or group of CGUs with either allocated goodwill or intangible assets with indefinite useful lives for which the carrying value of goodwill or intangible assets with indefinite useful lives are significant relative to the entity's total carrying value of goodwill or intangible assets with indefinite useful lives. For CGUs or groups of CGUs, the entity should disclose the following:

- The carrying amounts of goodwill or intangible assets with indefinite useful lives allocated.
- Basis used to determine recoverable amount (for example value in use or fair value less costs of disposal).
- If the recoverable amount is based on value in use,
  - a description of each key assumption, which is an assumption to which recoverable amount is most sensitive, on which management has based its cash flow projections for the period covered by the most recent budgets or forecasts.
  - a description of the approach management used to determine the value or values assigned to each key assumption, including whether these values
    - reflect past experience,
    - are consistent with external sources of information, if appropriate; or,
    - if not, an explanation describing why and how the assumptions differ from past experience or external sources of information.
  - the period of time over which management projected cash flows based on the most recent financial budgets or forecasts, approved by management and, if necessary, the justification for using a period longer than five years.
  - the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets or forecasts and, if necessary, the justification for using any growth rate that exceeded the long-term average growth rate for the products, industries, country or countries in which the entity operates, or the market to which the CGU or group of CGU's is dedicated.
  - the discount rate applied to the entity's cash flow projections.
- If the entity based recoverable amount on fair value less costs of disposal, the valuation techniques used. When the entity does not determine fair value less costs of disposal by reference to an observable market price for the CGU or group of CGUs, the entity should also disclose the following information:
  - Each key assumption on which management based its determination of fair value less costs of disposal.
  - A description of the approach management used to determine the value or values assigned to each key assumption and whether the assumptions
    - reflect past experience,
    - are consistent with external sources of information, if appropriate, and, if not,
    - an explanation describing why and how they differ from past experience or external sources of information.
  - The level of the fair value hierarchy in IFRS 13 in which the entity would categorize the fair value measurement in its entirety, without considering whether disposal costs can be observed.
  - A description of any change in valuation technique used and an explanation for the change.

6.87 If the entity determines that fair value less costs of disposal discounted cash flow projections, it should also disclose the period over which management has the projected cash flows, the extrapolated growth rate used, and the discount applied.

6.88 If a reasonably possible change in one or more of the key assumptions used in determining fair value less costs of disposal would cause the carrying amount to exceed the recoverable amount, the entity should disclose the following:

- The amount by which recoverable amount exceeds the carrying amount of the CGU(s)
- The value management assigned to the key assumption
- The amount the value assigned to the key assumption must change after incorporating any consequential effects of that change on the other variables used to measure the recoverable amount, so the recoverable amount of the CGU or group of CGUs would equal the carrying amount

Allocation of Goodwill or Intangible Assets With Indefinite Lives Across Multiple CGUs

6.89 An entity may allocate goodwill or intangible assets with indefinite useful lives across several CGUs or groups of CGUs. When the amount allocated to each CGU or group is not significant compared to the total carrying value of the entity's goodwill or intangible assets with indefinite useful lives, the entity discloses that fact and the aggregate carrying value of goodwill or intangible assets with indefinite useful lives allocated to those CGUs or groups of CGUs.

6.90 However, an entity should disclose additional information when the following conditions are met:

- The recoverable amounts of any of these CGUs or groups of CGUs are based on the same key assumptions.
- The aggregate carrying value of goodwill or intangible assets with indefinite useful lives allocated to these CGUs or groups of CGUs is significant in comparison with the entity's total carrying value of goodwill or intangible assets with indefinite useful lives.

6.91 The required disclosures are the following:

- The conditions in paragraph 6.90 are met.
- The carrying amount of goodwill or intangible assets with indefinite useful lives allocated to the relevant CGUs or group of CGUs.
- A description of the key assumptions and the approach management used to determine the value or values assigned to the key assumptions, including whether the key assumptions
  - — reflect past experience,
  - — are consistent with external sources of information, if appropriate, and,
  - — an explanation describing why and how they differ from past experience or external sources of information, if the key assumptions are not consistent.
- If a reasonably possible change in a key assumption would cause the aggregate of the carrying amount of the CGUs or groups of CGUs are greater than the aggregate of their recoverable amounts, the entity also discloses
  - — the amount by which the aggregate of the CGU's or group of CGU's recoverable amount exceeds the aggregate of their carrying amounts;
  - — the value management assigned to the key assumption; and
  - — the amount the value assigned to the key assumption must change after incorporating any consequential effects of that change on the other variables used to measure the recoverable amount, for the recoverable amount of the CGUs or groups of CGUs equal to their carrying amounts.

6.92 When an entity meets the criteria for using estimates of recoverable amount from a previous period, it should disclose the required information listed above as they relate to the previous calculation of recoverable amount. Refer to example 9 of the illustrative examples that accompany IAS 36 for guidance on these required disclosures.

Chapter 7

Leases

Overview

7.01 This chapter establishes the appropriate accounting policies and disclosures that lessees and lessors should apply to leases. A *lease*, as defined in International Accounting Standard (IAS) 17, *Leases*, is an agreement in which the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments. The salient point of IAS 17 is that a lease conveys the right to use an asset. Therefore, IAS 17 applies to agreements that transfer the right to use assets even when the lessee may call for the lessor to provide substantial services in connection with the operation or maintenance of the assets. However, IAS 17 does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting part to the other.

Summary of Selective Accounting Guidance

7.02 IAS 17 is the primary accounting literature for leases, unless another standard or requirement permits or requires a different treatment. International Financial Reporting Interpretations Committee (IFRIC) 4, *Determining Whether an Arrangement Contains a Lease*, establishes criteria that an entity should apply when evaluating whether an arrangement that does not take the legal form of a lease is—in substance—a lease and, therefore, the entity should account for the agreement, in whole or in part, in accordance with IAS 17. IFRIC 4 identifies the following criteria that indicate an arrangement contains a lease:

- Fulfillment of the arrangement depends on the use of one or more specific assets.
- The arrangement conveys a right to use the asset.

Scope

7.03 The recognition and disclosure requirements of IAS 17 apply to all leases, except for the following:

- Leases to explore for and use nonregenerative resources (for example, minerals, oil, and natural gas)
- Licensing arrangements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights

7.04 IAS 17 measurement requirements also apply to leases, except for the following:

- Property classified as investment property, in accordance with IAS 40, *Investment Property*
  - — Held by lessees and accounted for as investment property
  - — Provided by lessors under operating leases
- Biological assets in accordance with IAS 41, *Agriculture*
  - — Held by lessees under finance leases
  - — Provided by lessors under operating lessees

7.05 In May 2011, the International Accounting Standards Board issued International Financial Reporting Standard (IFRS) 13, *Fair Value Measurement*, effective for annual periods beginning on or after January 1, 2013. Paragraph 13 of IFRS 13 makes it clear that the measurement and disclosure requirements of that standard do not apply to leasing transactions within the scope of IAS 17. Paragraph 6A of IAS 17 also explains that its definition of fair value differs from that in IFRS 13. Therefore, when applying IAS 17, an entity measures fair value in accordance with IAS 17, not IFRS 13, except with respect to the scope exceptions listed in the previous paragraph.

Recognition and Measurement for Lessees

7.06 IAS 17 identifies the following types of leases:

- A *finance lease* is a lease that transfers substantially all significant risks and rewards incidental to ownership of the asset to the lessee, although the lessor may or may not eventually transfer title.
- An *operating lease* is a lease that is not a finance lease.

7.07 At the inception of the lease, IAS 17 requires both lessors and lessees to evaluate and classify a lease arrangement as either a finance lease or operating lease based on the terms and conditions of that agreement. They should not revisit the initial lease classification unless the terms and conditions of the lease change.

7.08 Classification of a lease as a finance or operating lease depends solely on whether the agreement transfers substantially all of the risks and rewards of ownership to the lessee. Such leases are classified as finance leases; all other leases are classified as operating leases. Whether the entity should classify a lease as a finance lease depends on the substance of the transaction, rather than the form of the contract. Lessees and lessors should arrive at the same classification for the same lease.

7.09 Paragraph 10 of IAS 17 provides the following situations in which lessees and lessors should normally classify a lease as a finance lease:

- Lease transfers ownership of the asset to the lessee at the end of the lease term.
- Lease contains a bargain purchase option; that is, the lessee can acquire the asset at an amount sufficiently below its fair value that it is reasonably certain the lessee will exercise the option.
- Lease term is for a major part of the economic life of the asset even if the lessor does not transfer title to the lessee.
- Present value of the minimum lease payments is at least substantially all of the leased asset's fair value at the inception of the lease.
- Leased assets are of such specialized nature that only the lessee can use the assets without major modifications.

7.10 Paragraph 11 of IAS 17 also provides several indicators of situations that individually or in combination could also lead to the finance lease classification:

- If the lessee can cancel the lease, the lessee bears the lessor's losses associated with the cancellation.
- Gains and losses from fluctuations in the fair value of the asset's residual value accrue to the lessee.
- Lessee has the ability to continue the lease for a subsequent period at a substantially lower rent than the market rent.

7.11 Paragraph 12 of IAS 17 explains that the indicators and situations described in the previous paragraphs are not always conclusive. Therefore, if it is clear from other features of the lease that it does not transfer substantially all risks and rewards incidental to ownership to the lessee, the lessee and lessor classify the lease as an operating lease.

Finance Leases

7.12 When the lessee classifies a lease as a finance lease, it should recognize a leased asset and a corresponding lease liability at the inception of the lease. The lessee measures both the leased asset and related lease liability at the lower of the fair value of the leased property or the present value of the minimum lease payments. To calculate the present value of the minimum lease payments, a lessee should use the interest rate implicit in the lease or, when it is impracticable for the lessee to determine the implicit rate, it should use its incremental borrowing rate as the discount rate. A lessee should also include its initial direct costs in the cost of the asset.

7.13 The lessee subsequently measures the lease liability and leased asset as follows:

- Lease liability
  - Use the effective interest rate method to allocate the minimum lease payments, including any guaranteed residual value, between the finance charge (interest expense) and the reduction of the lease liability.
  - Expense any contingent rents in the period they are incurred.
- Leased asset
  - Select a depreciation policy consistent with its policy for similar depreciable owned assets.
  - Recognize depreciation calculated on a systematic basis in accordance with IAS 16, *Property, Plant or Equipment*, or IAS 38, *Intangible Assets*, as appropriate.
  - Depreciate the asset fully over the shorter of the lease term or the asset's useful life when the lessee is reasonably certain that it will not obtain ownership by the end of the lease term.
  - Determine whether the asset is impaired in accordance with IAS 36, *Impairment of Assets*.

Operating Leases

7.14 A lessee recognizes operating lease payments as an expense in profit or loss on a straight-line basis over the lease term unless another systematic method is more representative of the pattern of benefits received, even when the amounts of the payments and the expense differ.

Recognition and Measurement for Lessors

Finance Leases

7.15 A lessor should recognize and present assets held by a lessee under finance leases as finance lease receivables in the balance sheet, measured at an amount equal to its net investment in the lease. A lessor should allocate the lease payment using the effective interest method to finance income and a return of principal.

7.16 *Initial direct costs* are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors. As a result, manufacturer and dealer lessors exclude these costs from their net investment in the lease and recognize an expense at the same time it recognizes profit on the sale. Normally, profit recognition begins at the commencement of the lease term for a finance lease. A manufacturer or dealer lessor should determine the period in which it will recognize profit or loss on the sale, in accordance with its policy for regular sales of the same asset. If the lessor quotes an artificially low rate of interest, paragraph 42 of IAS 17 restricts profit recognition to the amount of profit on the sale to an amount that would apply if it charged a normal market interest rate. The lessor should expense the costs of negotiating and arranging the lease at the same time the related profit or loss is recognized.

7.17 For finance leases other than those involving manufacturer or dealer lessors, the lessor includes any initial direct costs in the initial measurement of the finance lease receivable, which reduces the amount of income the lessor recognizes over the lease term. The lessor should define the interest rate implicit in the lease in such a way that the finance lease receivable automatically incudes the lessor's initial direct costs. The lessor should not need to include them separately.

Operating Leases

7.18 In its statement of financial position, a lessor should present assets held by lessees under operating leases by their nature; that is, as property, plant, and equipment or intangible assets. Generally, lessors should recognize lease income on a straight-line basis over the lease term.

Sales and Leaseback Transactions

7.19 A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sales price are usually interdependent because the counterparties negotiate these amounts as a package. The accounting treatment of a sale and leaseback depends on whether the resulting lease is a finance or operating lease.

Operating Lease

7.20 When the sale and leaseback transaction result in an operating lease and it is clear that the selling price is the fair value of the asset, the seller-lessee should recognize income immediately. However, if the selling price is greater than fair value, the seller-lessee defers and amortizes the excess of the selling price over fair value during the period the lessee expects to use the asset. If the selling price is less than fair value, the seller-lessee recognizes the loss immediately, unless the loss is attributable to below-market lease payments in the future. In the latter case, the seller-lessee defers and amortizes the loss over the period the lessee expects to use the asset.

Finance Lease

7.21 When a sale and leaseback transaction results in a finance lease, the transaction is a financing arrangement, not a sale. The lessor provides the financing to the seller-lessee, with the asset as collateral. Therefore, the seller-lessee should not recognize income for any excess of the proceeds from the sale over the carrying amount of the asset. Instead, the seller-lessee should defer and amortize any excess over the lease term. When the difference between the proceeds from the sale and the asset's carrying amount is negative (loss), no adjustment to the asset's carrying amount is necessary, unless the asset is impaired. When the asset is impaired, the seller-lessee should reduce the asset's carrying amount to recoverable amount in accordance with IAS 36.

Presentation

7.22 IAS 1, *Presentation of Financial Statements*, does not require an entity to present leased assets, lease liabilities, or related revenues or expenses as separate line items in the relevant financial statement. However, lessees and lessors should apply other relevant requirements of IAS 1. In accordance with the prohibition against offsetting in IAS 1, lessees with finance leases should not present lease liabilities as a deduction from the leased assets.

7.23 When an entity presents a classified balance sheet, both lessees and lessors with finance leases should allocate the lease liability and leased financial receivables, respectively, between the current and noncurrent classifications.

7.24 Unless an item of income or expense is material, neither IAS 1 nor IAS 17 require an entity to present income or expense items associated with lease agreements separately in the statement of profit or loss and other comprehensive income.

Disclosure

7.25 In addition to the disclosure requirements of IAS 17 that follow, the scope of IFRS 7, *Financial Instruments: Disclosures*, includes leases and is applicable to both lessees and lessors. In addition, the disclosure requirements of IAS 16, IAS 36, IAS 38, and IAS 40 apply to lessors for assets provided under operating leases.

Lessees

7.26 A lessee with a finance lease should disclose the following information:

- For each class of asset, the net carrying amount at the end of the reporting period
- Reconciliation of the total future minimum lease payments and their present value at the end of the current period

- Total of future minimum lease payments at the end of the reporting period and their present value for each of the following periods:
  - Not later than one year
  - Later than one year but not later than five years
  - Later than five years
- Contingent rents recognized as expense in the period
- Total of future minimum sublease payments expected to be received under noncancellable subleases at the end of the reporting period
- A general description of the lessee's material leasing arrangements including, but not limited to, the following information:
  - Basis on which contingent rent payable is determined
  - Existence and terms of lease renewal or purchase options and escalation clauses, if any
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing

7.27 Lessees with operating leases should disclose the following information:

- Total of future minimum lease payments for each of the following periods:
  - Not later than one year
  - Later than one year but not later than five years
  - Later than five years
- Total of future minimum sublease payments expected to be received under noncancellable subleases at the end of the reporting period
- Lease and sublease payments recognized as expense during the period, with separate disclosure of minimum lease payments, sublease payments, and contingent rents
- A general description of the lessee's material leasing arrangements including, but not limited to, the following information:
  - Basis on which contingent rent payable is determined
  - Existence and terms of lease renewal or purchase options and escalation clauses, if any
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing

Lessors

7.28 Lessors with finance leases should disclose the following information:

- Reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period
- Gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, and for each of the following periods:
  - Not later than one year
  - Later than one year but not later than five years
  - Later than five years
- Unearned finance income
- Unguaranteed residual values accruing to the benefit of the lessor
- Accumulated allowance for uncollectible minimum lease payments receivable
- General description of the lessor's material leasing arrangements

7.29 Lessors with operating leases should disclose the following information:

- Total of future minimum lease payments at the end of the reporting period and their present value for each of the following periods:
  - Not later than one year
  - Later than one year but not later than five years
  - Later than five years
- Contingent rents recognized as expense in the period
- General description of the lessor's leasing arrangements

Sale and Leaseback Transactions

7.30 Paragraph 65 of IAS 17 requires the lessees and lessors in sale and leaseback transactions to provide the same disclosures as other lessees and lessors. In the required description of material leasing arrangements, lessees and lessors in sale and leaseback transactions should disclose the unique or unusual provisions of the agreement or terms of the sale and leaseback transaction. In addition, sale and leasebacks may require separate disclosure under IAS 1.

Chapter 8

Investments in Associates and Joint Arrangements

Overview

8.01 This chapter establishes the accounting for investments in associates and joint ventures and describes how an entity applies the equity method when accounting for investments in associates or joint ventures. An *associate* is defined as an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence; which is the power to participate in, but not control, the financial and operating policy decisions of the investee. In contrast, a *joint arrangement* has the following characteristics:

- The parties are bound by a contractual agreement.
- The contractual agreement gives two or more of those parties joint control of the arrangement.

8.02 International Financial Reporting Standards (IFRSs) define two types of joint arrangements: joint operations and joint ventures. A *joint operation* is a joint arrangement in which the parties with joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. In contrast, a *joint venture* is a joint arrangement in which the parties to the arrangement have joint control over, and rights to, the net assets of the arrangement.

8.03 Therefore, associates, joint operations, and joint ventures are not subsidiaries (controlled entities) of the reporting entity.

Summary of Selected Accounting Guidance

8.04 International Accounting Standards (IAS) 28, *Investments in Associates*, is the primary accounting literature for guidance on how an entity accounts for investments in associates or joint ventures in its consolidated financial statements. IFRS 11, *Joint Arrangements*, establishes the principles for financial reporting by an entity that has an interest in arrangements that the entity jointly controls. IFRS 12, *Disclosure of Interests in Other Entities*, issued in May 2011, describes the required disclosures about an entity's investments in associates or joint ventures. Both IAS 28 and IFRS 12 are effective for annual reporting periods beginning on or after January 1, 2013. IAS 28 supersedes IAS 28, *Investments in Associates and Joint Ventures*, as revised in 2003.

8.05 The entity accounts for any joint operations in accordance with IFRS 11 in both its consolidated and separate financial statements. However, in its separate financial statements, a parent entity accounts for its investments in associates and joint ventures in accordance with paragraph 10 of IAS 27, *Separate Financial Statements*. Refer to chapter 29 of this book; paragraphs 26–27 in IFRS 11; and paragraph 44 in IAS 28 for additional guidance on consolidated and separate financial statements.

Scope and Scope Exceptions

8.06 IFRS 11 applies to all entities that are party to a joint arrangement. Although IFRS 11 establishes the accounting for joint operations, the standard requires an entity to account for a joint venture using the equity method in accordance with IAS 28, unless the entity is exempt from applying the equity method as described in the following paragraph.

8.07 IAS 28 requires an entity to account for its investments in associates and joint ventures using the equity method and applies to all entities that are investors with joint control or significant influence over an investee. However, IAS 28 exempts the following entities from applying the equity method:

- A parent entity that is exempt from preparing consolidated financial statements by the scope exemption in IFRS 10 or if all of the following conditions apply:
  - The entity is a wholly- or partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.
  - The entity's debt or equity instruments are not traded in a public market (whether domestic or foreign stock exchange or over-the-counter market, including local and regional markets).
  - The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.
  - The ultimate or any intermediate parent of the entity produces consolidated financial statements available for public use that comply with IFRSs.
- An entity that elects to measure its investments in associates and joint ventures at fair value through profit or loss, such as one of the following:
  - Venture capital organizations.
  - Mutual funds, unit trusts, and similar entities, including investment-linked insurance funds.

Such entities should account for these investments in accordance with IFRS 9, *Financial Instruments*, which was issued in November 2009 and again in October 2010 with an effective date of January 1, 2015. Refer to chapter 17 for additional guidance on financial assets held at fair value through profit or loss.

8.08 In addition, IAS 28 requires an entity to account for investments in associates and joint ventures classified as held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. Refer to IFRS 5 and chapter 18 in this book for guidance on accounting for investments in associates and joint ventures classified as held for sale.

Recognition and Measurement: Joint Operations

8.09 A joint operator should recognize the following items with respect to its interest in a joint operation:

- Its assets, including its share of assets acquired jointly
- Its liabilities, including its share of liabilities incurred jointly
- Its revenue from the sale of its share of the output of the joint operation
- Its share of the revenue from the sale of the output of the joint operation
- Its expenses, including its share of expenses incurred jointly

Recognition and Measurement: Associates and Joint Ventures

Significant Influence

8.10 An entity applies the guidance in IAS 28 when it is evident that it has significant influence over an investee. It is presumed that an entity has significant influence over an investee if it holds, directly or indirectly, 20 percent or more of the voting power of the investee. For example, the entity may hold more than 20 percent of the voting power of an investee through its subsidiaries' investment in the investee. It is also presumed that, if the entity holds less than 20 percent of the voting power in an investee, it does not have significant influence.

8.11 The following are indicators of the existence of significant influence by an investor:

- The entity is a member or is represented on the investee's board of directors or governing board.
- The entity participates in the investee's policy-making process, including participation in decisions regarding dividends or other distributions.
- There are material transactions between the entity and the investee.

- There is an interchange of management personnel between the entity and the investee.
- The entity provides essential technical information to the investee.

8.12 When assessing whether it has significant influence over an investee, an entity should consider potential voting rights, such as share call options, warrants, and convertible financial instruments, only when these instruments are currently exercisable or convertible. As part of this process, an entity should consider all facts and circumstances that affect these potential rights. For example, the entity should consider the terms and conditions of exercise and other contractual arrangements individually and in combinations. However, the entity should not consider management's intentions or the entity's financial ability to exercise or convert its potential rights.

8.13 An entity no longer has significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of an investee. Loss of significant influence may occur with or without changes in absolute or relative ownership levels. For example, the entity may lose significant influence because the investee becomes subject to control by a government, court, administrator, regulator, or by contractual arrangement.

Equity Method

8.14 An entity should apply the equity method to account for an investment in associates or joint ventures by using the equity method when the entity

a. has significant influence or joint control over the investee, and

b. is not exempt or prohibited from applying the equity method, as described in paragraphs 17–21 of IAS 28.

8.15 An entity with significant influence or joint control over an investee has an interest in the investee's performance and, as a result, the return on its investment. However, income recognition based upon investee distributions to the entity may not adequately reflect the income the entity earned on its investment. It is preferable for the entity to recognize income based on the investee's earnings and recognize a change in its net assets based on the change in the investee's net assets.

8.16 Therefore, the equity method requires the entity to account for its investment in an associate or joint venture as follows:

- Recognize its proportionate share (percent ownership interest) of the investee's net income (net loss) in its own statement of profit or loss.
- Recognize its proportionate share of the investee's other comprehensive income in its own statement of other comprehensive income in accordance with IAS 1, *Presentation of Financial Statements*.
- Adjust the carrying amount of its investment for these changes in profit or loss and other comprehensive income (for example, changes due to revaluation of property, plant, and equipment or foreign currency translation).
- Adjust the carrying amount of its investment for its proportionate share of dividends declared by the investee.

8.17 Consequently, the net effect on its investment in the associate or joint venture should mirror the change in net assets of the investee from comprehensive income and dividend declarations.

8.18 The entity determines its proportionate share of the investee's profit or loss or other comprehensive income based on present ownership interests. If potential voting rights exist from convertible or exercisable instruments, the entity does not include the possible exercise or conversion when determining changes in the investee's equity.

8.19 When an investment in an associate or a joint venture previously classified as held for no longer meets the classification criteria in IFRS 5, the entity uses the equity method to account for the investment from the date of its original classification as held for sale. The entity retrospectively restates all financial statements for the periods since it classified the investment as held for sale.

8.20 The entity discontinues use of the equity method from the date the investment ceases to be an associate or joint venture as follows:

- If the investment becomes a subsidiary (a controlled entity), the entity should account for the investment in accordance with IFRS 3, *Business Combinations*, and IFRS 10, *Consolidated Financial Statements*.
- In accordance with IFRS 9, *Financial Instruments*, the entity measures at fair value any investment it retains in the former associate or joint venture that is a financial asset. The investor should also recognize in profit or loss any differences between the following:
  - The fair value of any retained investment and the proceeds, if any, from disposing of its part interest in the associate or joint venture; and
  - The carrying amount of the investment at the date it discontinued use of the equity method.

8.21 When the entity discontinues use of the equity method, it should account for all amounts previously recognized in other comprehensive income in relation to that investment on the same basis that would have been required if the investee had disposed of the related assets and liabilities directly. If a gain or loss previously recognized by an investee in other comprehensive income would be reclassified to profit or loss on the disposal of the related asset or liabilities, the entity would also reclassify the gain or loss from equity to profit or loss when it discontinued use of the equity method. However, if the investee would transfer a gain or loss previously recognized in other comprehensive income directly to retained earnings, then the entity would also transfer its proportionate share of the gain or loss to retained earnings.

8.22 For example, assume an investee had previously recognized a revaluation increase in other comprehensive income and the entity had recognized its proportionate share in its own other comprehensive income. If the investee disposed of the asset, it would transfer the amount of the revaluation increase to retained earnings in accordance with its accounting policy and with IAS 16, *Property, Plant and Equipment*. Therefore, if the entity discontinues use of the equity method, it would also transfer its proportionate share of the revaluation increase to retained earnings.

8.23 If an investment in an associate becomes an investment in a joint venture, or vice versa, the entity continues to apply the equity method and does not remeasure the retained interest.

Application of the Equity Method

8.24 Many of the procedures an entity uses to apply the equity method are similar to the consolidation procedures described in IFRS 10, as are the concepts underlying the procedures used in accounting for the acquisition of a subsidiary.

8.25 An entity, which includes its consolidated subsidiaries, sometimes engages in transactions with an associate or joint venture. Such transactions include sales of goods; services; assets to or from the associate; or lending to or borrowing from an associate. To the extent that such transactions affect profit or loss of either the entity or the investee, the entity recognizes profit or loss in its consolidated financial statements only to the extent of the unrelated investor's interest in the associate or joint venture. The entity should eliminate its share in the associate's or joint venture's profits and losses resulting from these transactions. However, an entity recognizes in full any impairment losses, including write-downs of inventory to net realizable value, on assets transferred or sold to an associate or joint venture.

8.26 The entity applies the equity method to its investment in an associate or joint venture on the date the investment becomes an associate or joint venture. The entity accounts for any difference between the cost of the acquired investment and its share of the net fair value of the investee's identifiable assets and liabilities as follows:

- Include goodwill relating to the acquisition of an associate or a joint venture in the carrying amount of the investment and do not amortize such goodwill.
- Include any excess of the entity's share of the net fair value of an associate's identifiable assets and liabilities over the cost of the investment in income when determining its share of the associate's profit or loss in the period it acquired the investment.

8.27 The entity should also make appropriate adjustments to its share of an associate's or joint venture's profit or loss to account for, for example, depreciation of the assets acquired based on their fair values at the date of acquisition, or impairment losses for goodwill or property, plant and equipment recognized by the investee.

8.28 When applying the equity method, the entity uses the associate's or joint venture's most recent available financial statements. When the end of the entity's reporting period differs from that of the associate or joint venture, the associate or joint venture should do the following:

- Prepare its financial statements as of the same date as those of the entity, unless it is impracticable to do so.
- If it is impracticable to prepare its financial statements as of the same date as the entity, adjust its financial statements for the effects of significant transactions or events that occur between its end-of-period date and the date of the investor's financial statements.

8.29 Regardless, IAS 28 requires the difference between the entity's, associate's, or joint venture's end of the reporting period to be no more than three months and requires the length of the reporting periods and any difference between the ends of the reporting periods to be the same from period to period.

8.30 The investor should apply uniform accounting policies for like transactions and events in its consolidated financial statements. Therefore, in applying the equity method, if an associate or joint venture uses different accounting policies from those of the entity, the entity should adjust the associate's accounting policies to confirm to its own policies.

8.31 The entity adjusts its share of the associate's or joint venture's profit or loss for any dividends, whether declared or not, on the associate's or joint venture's outstanding cumulative preferred shares that are classified as equity and held by parties other than the investor.

8.32 An entity ceases to recognize its share of losses of an associate or joint venture when recognized losses equal or exceed the entity's interest in the associate or joint venture. For purposes of applying the equity method, an entity's interest in an associate or joint venture equals the carrying amount of the investment plus any long-term interests that, in substance, form part of the investor's net investment in the associate or joint venture. Such long-term interests may include an item for which settlement is neither planned nor likely to occur in the foreseeable future, such as the following:

- Preferred shares
- Long-term receivables or loans, not including trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans

8.33 After recognition of an associate's or joint venture's losses has reduced the carrying value of the entity's investment to zero, the entity applies additional losses to other components of its interest in the associate or joint venture in reverse order of their seniority (that is, the priority of the component in liquidation). When loss recognition has reduced the carrying value of all components of the entity's interest to zero, the entity should recognize additional losses as a liability only to the extent the entity has incurred a legal or constructive obligation to make payments on behalf of the associate or joint venture. The entity only recognizes subsequent profits of the associate or joint venture only after its share of the profits equals its unrecognized losses.

8.34 After applying the equity method, including loss recognition as described previously, an entity assesses its net investment in the associate or joint venture for impairment. The entity also applies IAS 39, *Financial Instruments: Recognition and Measurement*, to determine whether it should recognize an additional impairment loss on any components of its interest in the associate or joint venture that do not form part of its net investment.

8.35 Whenever IAS 39 indicates the asset may be impaired, the entity tests the carrying amount of the net investment as a single asset in accordance with IAS 36, *Impairment of Assets*. The impairment test in IAS 36 compares the recoverable amount of the investment in the associate or joint venture with its carrying value. *Recoverable amount* is the higher of the asset's value in use and its fair value less the costs to sell.

8.36 IAS 28 identifies two approaches for determining the investment's value in use. The entity should estimate either

a. its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

b. the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and its ultimate disposal.

8.37 IAS 28 states that, when the entity uses appropriate assumptions, both methods provide the same results.

8.38 The entity should separately assess the recoverable amount of each investment in an associate or joint venture unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity. In addition, because the entity cannot separately test any goodwill recognized as part of its net investment, it does not allocate any impairment to such goodwill and may record a reversal of any impairment losses up to recoverable amount. In other words, because the entity did not reduce the goodwill included in the net investment in the associate or joint venture, the prohibition against reversal of a goodwill impairment loss in IAS 36 does not apply.

Disclosure

8.39 IFRS 12 requires significant disclosures with respect to an entity's interests in other entities, including interests in associates, joint operations, and joint ventures. The basic principle is that an entity should disclose information that enables users of its financial statements to evaluate the following:

- Nature, extent, and financial effects of its interests in associates and joint ventures
- Nature of, and changes in, the risks associated with these interests

8.40 The following are some of the disclosures required for an entity's investments in an associate or joint venture that are individually material to the reporting entity:

- Whether the entity measures its investment using the equity method or at fair value through profit or loss
- Summarized financial information about associate or joint venture as specified in paragraphs B12–B13 of the application guidance within IFRS 12
- If the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, whether there is a quoted market price for the investment
- Financial information as specified in paragraph B16 of the application guidance within IFRS 12 about the entity's investments in joint ventures and associates that are not individually material in the aggregate for all individually immaterial joint ventures and, separately, associates
- When the financial statements of a joint venture or associate used in applying the equity method are as of a date or for a period that is different from that of the entity,
  - date of the end of the reporting period of the financial statements of that joint venture or associate
  - the reason for using a different date or period
- The unrecognized share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognizing its share of losses of the joint venture or associate when applying the equity method

Chapter 9

Investment Property

Overview

9.01 An entity may hold property, land, or buildings (or any combination of those) as an investment to earn rental income, for capital appreciation, or both. Such property may not be different in nature from *owner-occupied property*; that is, land or buildings, or both, used for administrative proposes or in the production or supply of goods or services, but it is distinctively different in the purpose for which the entity holds the property.

9.02 Examples of investment property include the following:

- Land held idle for long-term capital appreciation
- Land held for a currently undetermined future use because the entity has not yet decided how it will use the land
- Buildings owned (or held by the entity under a finance lease) and leased, or if vacant, with the intent to lease, to lessees under operating lease arrangements
- Investment property under construction or future development

9.03 This chapter describes the accounting treatment for those investment properties that fall within its scope.

Summary of Selected Accounting Guidance

9.04 The primary accounting literature relating to accounting for investment property is International Accounting Standard (IAS) 40, *Investment Property*. IAS 40 includes guidance that relates to the measurement of investment properties and certain lease arrangements. IAS 17, *Leases*, is the primary accounting literature for leases.

9.05 IAS 16, *Property, Plant and Equipment*, prescribes the accounting treatment for owner-occupied property that the entity uses for administrative purposes or in production or supply of goods or services. An entity accounts for land or buildings, or both, held for sale in the ordinary course of business, classified as inventory, in accordance with IAS 2, *Inventories*. Refer to chapters 7, "Leases;" 5, "Property, Plant, and Equipment;" and 3, "Inventory," of this book for a detailed discussion of the accounting guidance described in IAS 17, 16, and 2, respectively.

Scope and Scope Exceptions

9.06 IAS 40 and this chapter apply to the accounting treatment of all land and buildings classified as investment properties, including recognition, measurement, and disclosure. In addition, the scope of IAS 40 includes the measurement of investment property in the following:

- Financial statements of a lessee that accounts for its interest in investment property held under a lease classified as a finance lease
- Financial statements of a lessor that provides investment property to a lessee under an operating lease

9.07 Neither IAS 40 nor this chapter addresses the following matters that are accounted for in accordance with IAS 17:

- Classification of leases as finance or operating leases
- Disclosures about financial or operating leases
- Recognition in accordance with IAS 18, *Revenue*, of lease income from investment property
- Measurement in the financial statements of
  - — a lessee's property interest held under a lease accounted for as an operating lease
  - — a lessor's net investment in a finance lease
- Accounting for sale and leaseback transactions

9.08 IAS 40 and this chapter also do not apply to the following:

- Biological assets related to agricultural activities accounted for in accordance with the guidance found in IAS 41, *Agriculture*[1]
- Mineral rights and reserves, such as oil, natural gas, and similar nonregenerative resources

9.09 The following are not investment properties and, therefore, outside the scope of IAS 40 and this chapter:

- Owner-occupied property as described previously accounted for in accordance with the guidance in IAS 16
- Land or buildings, or both, held, or being constructed or developed, for sale in the ordinary course of business, classified as inventory, and accounted for in accordance with the guidance in IAS 2
- Property held under a finance lease and leased to another entity, which are accounted for in accordance with the guidance in IAS 17
- Construction or development of land or buildings, or both, on behalf of a third party, which are accounted for in accordance with the guidance in IAS 11, *Construction Contracts*[2]

9.10 Property that is leased to or occupied by an entity's parent, or another subsidiary, does not qualify as investment property because it is considered owner-occupied and is classified as property, plant, and equipment in the parent's consolidated financial statements. However, if the property meets the definition of investment property, the entity that owns the property should account for it as investment property in its individual financial statements.

Recognition

9.11 An entity should recognize an investment property as an asset when the following asset recognition criteria in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting* are met:

- *Probability criteria*. It is probable the investment property will generate future economic benefits that will flow to the entity.
- *Measurement reliability criteria*. The entity can measure the cost reliably.

9.12 An entity recognizes the costs of investment property at the time it incurs these costs, including the initial costs to acquire the investment property and subsequent costs to service or replace part of the property. An entity does not include the costs of general repairs and maintenance in the carrying amount of the investment property, but expenses these costs in profit and loss as incurred. Such costs may include the cost of day-to-day servicing or minor part replacement.

9.13 In accordance with paragraph 19 of IAS 40, when an entity replaces part of an investment property, it recognizes the replacement cost in the carrying amount of the investment property and derecognizes the carrying amount of the parts being replaced.

9.14 If an entity is a lessee leasing an investment property as an operating lease, it may account for the property as investment property, providing

a. the property would otherwise meet the definition of an investment property, and

b. the lessee uses the fair value model described in paragraphs 33–52 of IAS 40.

9.15 This classification is available on a property-by-property basis. However, once an entity selects this classification alternative for one property, the entity should use the fair value model for all property classified as investment property.

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[1] Guidance regarding International Accounting Standard (IAS) 41, *Agriculture*, has not been included for discussion because it is beyond the scope of this book.

[2] Guidance regarding IAS 11, *Construction Contracts*, has not been included for discussion because it is beyond the scope of this book.

9.16 Circumstances sometimes will require an entity to exercise judgment when determining whether a particular property meets the definition of an investment property. Examples of when an entity may need to exercise judgment in this regard include the following:

- A property earns rental income and is used in the supply of the entity's goods or services; for example, an entity owns a building that houses a retail outlet for its products on the ground level and the remaining floors are leased to others as office space. If these two portions—the retail space and the office space—can be sold separately or leased separately under a finance lease, then the entity should also account for each portion of the property separately. If the property cannot be sold separately, the entity can only classify the property as investment property if the portion used by the entity is insignificant relative to the asset as a whole.
- The entity that owns the investment property provides additional services to occupants of the property (for example, providing security and maintenance). Such services will not change the classification of the property as investment as long as these ancillary services are insignificant to the arrangement as a whole. If those services are significant, the entity should classify the property as owner-occupied and account for it in accordance with the guidance of IAS 16. It is likely that the entity will need to consider all relevant facts and circumstances and use its judgment to determine whether an ancillary service is significant to the arrangement or not.

Initial Measurement

9.17 An entity measures an investment property initially at cost, which includes the cost to purchase the property and other directly attributable transaction costs, such as legal or other professional fees, property transfer taxes, and other related costs. An entity should not include the following costs in the initial measurement of an investment property:

- Start-up costs, providing these costs are not necessary for the property to operate as management intends
- Operating losses incurred before the property reaches the planned level of occupancy
- Abnormal amounts of labor, material waste, or other resources incurred when the entity constructs or develops the property

9.18 IAS 40 provides guidance for the following circumstances that involve the initial cost measurement of an investment property:

- When payment is deferred on the property's purchase, the entity recognizes the property's cash price equivalent as its cost. The entity defers the difference between the total payments and the cash price equivalent and recognizes this amount over the period of the credit as interest expense.
- When a property interest is classified as investment property and held under a lease, the entity accounts for the lease as a finance lease. In accordance with paragraph 20 of IAS 17, the entity measures the leased asset at the lower of the fair value of the property and the present value of the minimum lease payments, which includes any premiums paid. The entity also recognizes a lease liability of the same amount less the premiums paid.
- When an entity acquires an investment property through a nonmonetary exchange of assets, it measures the cost of the investment property as follows:
  - At either the fair value of the asset given or the fair value of the asset received, whichever is more clearly evident, when the transaction has commercial substance; or
  - At the carrying value of the asset given up when either
    - the transaction lacks commercial substance; or
    - the entity cannot measure the fair value of either of the assets exchanged reliably.

Even if the entity cannot immediately derecognize the property given up, the entity measures the property acquired. Refer to chapter 5 in this book and IAS 16 for additional guidance to determine whether a transaction has commercial substance, whether fair value can be measured reliably, and other aspects of asset exchanges.

Subsequent Measurement

Accounting Policy

9.19 After the initial recognition of an investment property, an entity should choose whether to use the cost model or the fair value to measure its investment properties going forward. Selection of an accounting model is an accounting policy choice. An entity may make an accounting policy decision separately for the following investment properties:

- All investment properties backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property
- All other investment properties

9.20 In addition, when an entity classifies a property interest held by a lessee under an operating lease as an investment property, IAS 40 requires the entity to choose the fair value model for these properties.

9.21 An entity may voluntarily elect to change the measurement model, provided that the change results in reliable and more relevant information for the users of its financial statements. However, it is highly unlikely that a more relevant measurement would result from a change from the fair value to the cost mode. An entity accounts for a change in accounting policy in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

9.22 Paragraph 32 of IAS 40 requires all entities to determine the fair value of an investment property for the following purposes:

- Measurement if it uses the fair value model
- Disclosure if it uses the cost model

9.23 IAS 40 encourages, but does not require, an entity to use an independent valuation expert, who holds a recognized and relevant professional qualification and has recent experience in the property location and category, to determine the fair value of investment property.

9.24 If a portion of the investment is held by investors in a fund with contracts that are linked to other properties held, IAS 40 does not permit an entity to measure different parts of these funds at cost and fair value. If an entity chooses to use different models for the categories described in paragraph 32C of IAS 40

- the entity recognizes a sale of investment property between pools of assets measured under different models at fair value and the cumulative change in fair value in profit or loss.
- when an investment property is sold from a pool measured under the fair value model to a pool measured under the cost model, the fair value at the date of the sale becomes the property's deemed cost.

Cost Model

9.25 Under the cost model, the entity measures investment properties subsequently in accordance with

- the requirements of the cost model in IAS 16. Refer to chapter 5 in this book for a detailed description of this model.
- International Financial Reporting Standard (IFRS) 5, *Non-current Assets Held for Sale and Discontinued Operations*, if the entity classifies the investment property as held for sale, or included in a disposal group that is held for sale.

Fair Value Model

9.26 Under the fair value model, subject to the alternatives described previously, an entity should measure all of its investment properties at fair value, including property interests classified as investment property that is held by a lessee under an operating lease. An entity should recognize gains or losses that arise from changes in fair value in profit or loss in the period the changes occur.

9.27 An investment property's fair value is the price at which the property could be exchanged in an arm's length transaction between knowledgeable willing parties. Fair value excludes estimated prices that may be over- or understated due to special terms and circumstances, and excludes transaction costs that the entity may incur when it sells or disposes of the investment property.

9.28 Fair value is time specific. The entity should reflect market conditions existing at the end of a reporting period in the investment property's fair value.

9.29 An investment property's fair value should reflect

a. rental income from current leases and other market assumptions used in current market conditions; and

b. any expected cash outflows, including contingent rent payments, that are expected to become payable.

9.30 The entity remeasures the fair value of its interest in leased property when necessary. In a lease negotiated at market rates, the fair value of its interest in a leased property at acquisition, net of all expected lease payments (including those relating to recognized liabilities), should be zero, in accordance with the guidance in paragraph 41 of IAS 40. Thus, the fair value of the lease does not change for accounting purposes when the entity recognizes the leased asset and liability at fair value or at the present value of minimum lease payments in accordance with IAS 17. Therefore, remeasurement of a leased asset from cost to fair value should not give rise to initial gains or losses, unless fair value is measured at different times. This could occur when an entity elects the fair value model after initial recognition of the leased asset and liability.

9.31 Typically, the best evidence of fair value is current prices in an active market for similar properties, subject to similar lease and other contracts. In the absence of this evidence, an entity may consider the following in order to arrive at the most reliable estimate within a range of fair value estimates:

- Current prices in an active market for different properties and leases, and adjusting for those differences
- Recent prices in a less market for similar properties and leases, and adjusting for changes in economic conditions since the date of the transaction
- Discounted cash flow projections based on reliable estimates of future cash flows, supported by an existing lease and other contract terms and, if available, external evidence such as current market rents for similar properties, using discount rates to reflect market assessments of the uncertainty in the amount and timing of cash flows

9.32 In rare circumstances, an entity has evidence at the initial recognition of the investment property that a range of reasonable fair value estimates exists, with various probabilities and outcomes. Therefore, in these circumstances, using a single estimate would not be helpful and this may indicate that the entity may not be able to measure fair value reliably in the future.

9.33 When determining the carrying amount of an investment property under the fair value model, an entity does not double-count assets or liabilities that are recognized separately. For example, equipment that is an integral part of a building, such as the air conditioner or elevator, is often an integral part of a building and is generally included in the fair value of the property rather than separately as property, plant, and equipment.

9.34 When the present value of payments relating to the investment property exceeds the present value of related cash receipts for an investment property, the entity determines whether to recognize and measure a liability in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Inability to Measure Fair Value Reliably

9.35 There is a rebuttable presumption that an entity that uses the fair value model can always measure the fair value of its investment properties reliably. Under rare circumstances, however, an entity may not be able to continue to reliably measure the fair value of its properties, but this occurs only when comparable market transactions and other alternative reliable estimates of fair value are not available.

9.36 For investment property under construction, the entity can only rebut the presumption that fair value cannot be measured reliably only on initial recognition. In this case, the entity should measure the investment property at cost until it is able to reliably measure the property at fair value or when construction is complete. There is a presumption that once the property is ready for use that its fair value can be measured reliably. If this is not the case, the entity should measure the investment property using the cost model in accordance with IAS 16.

9.37 In the rare case that an entity is compelled to use the cost model for individual properties under construction or other properties, the entity should continue to account for remaining properties under the fair value model.

9.38 When an investment property has previously been measured using the fair value model, the entity should continue to measure the property at fair value, until it derecognizes or disposes of the property, even if comparable market information becomes available less frequently.

Transfers

9.39 An entity may change its use of an investment property and may need to transfer property to or from classification as investment property. The transfers to, or from, investment property should be made when, and only when, there is a change in the use of this property. The following are examples of evidence when a change in classification is warranted:

- Transfers of property into investment property require
  - end of owner-occupation of the property, or
  - start of an operating lease to another party when the transfer involves properties classified as inventory.
- Transfers of property out of investment property
  - start of owner occupation (for example, the property will be used in production), or
  - start of development with the intention to sell the property (classification as inventory). If the entity does not develop and sell the property, the entity does not classify and account for the property as inventory. It should continue to be classified as investment property until it is derecognized.

9.40 When existing investment property is redeveloped for future use and the entity's intention is to continue using the property as investment property, it remains classified as investment property and is not reclassified as owner-occupied property during redevelopment.

Transfers Under the Cost Model

9.41 When an entity transfers investment property measured using the cost model to owner-occupied property, the entity does not change the carrying amount of the property transferred for either measurement or disclosure purposes.

Transfers Under the Fair Value Model

9.42 When an entity transfers investment property carried at fair value to owner-occupied property or inventory, the fair value at the date the property changed use becomes its deemed cost. Subsequently, an entity should account for the property in accordance with

- IAS 16, when the property is transferred into owner-occupied property.
- IAS 2, when the property is transferred for use as inventory.

9.43 When an owner-occupied property carried at revalued amount is transferred to investment property, the entity applies the guidance in IAS 16 up to the date of change. The difference, if any, that arises between the carrying amount of the revalued asset under IAS 16 and its fair value under IAS 40 is treated as a revaluation increase or decrease under the guidance of IAS 16. In addition, up to the date of the transfer, the entity continues to recognize depreciation and impairment losses in accordance with IAS 16. On subsequent disposal of the investment property, the entity transfers any remaining revaluation surplus included in equity to retained earnings, not profit or loss. Refer to chapter 5 in this book for guidance regarding the revaluation of property in accordance with IAS 16.

9.44 When property classified as inventory is transferred to investment property measured using the fair value model, an entity should recognize any differences between its carrying value in inventory and its fair value at the date of transfer in profit or loss. This treatment is consistent with the treatment of inventories sold in accordance with IAS 2.

9.45 When an entity completes a self-constructed investment property that it will measure at fair value, it recognizes the difference between its carrying amount and its fair value at the completion date in profit or loss.

Disposals

9.46 An entity should derecognize an investment property when disposed of, or when permanently withdrawn from use and the entity expects no future economic benefits.

9.47 An entity can achieve derecognition in the following ways:

- By selling the investment property in accordance with IAS 18
- By entering into a financing lease arrangement in accordance with IAS 17

9.48 When parts of an investment property are replaced and the entity did not expense the cost of those parts as incurred, it should recognize the carrying amounts of these replacement parts in the carrying amount of the investment property. The entity should derecognize the carrying amount of the original parts. The entity would derecognize the original parts as follows:

- Under the cost model:
  - If the carrying amount of the original part is known or determinable, the entity should derecognize the original part at that amount.
  - If the carrying amount of the original part cannot be determined, then the entity may use the cost of the replacement part at the time it was constructed or acquired as an indication of the original part's carrying amount. Under this model, the replaced parts may not be depreciated separately.
- Under the fair value model:
  - The fair value of the investment property should already reflect the decline in fair value of the part being replaced. It may be difficult to determine how much of the overall decline in value applies to that part.
  - When it is impracticable for the entity to determine the fair value of the part directly, an alternative to reducing the value of the property for the replaced part is for the entity to include the cost of the replacement in the carrying amount of the asset and reassess the fair value of the investment property as a whole, as would be required for additions not involving replacement.

9.49 An entity measures gains or losses that arise from disposal of investment property as the difference between the property's carrying amount and the net proceeds from disposal. The entity recognizes these gains or losses in the period it retired or disposed of the property, unless IAS 17 requires otherwise on a sale and leaseback transaction.

9.50 An entity recognizes receivables from the disposal of investment properties initially at fair value. If there is a difference between the cash price equivalent and the nominal amount received, the entity recognizes this difference as interest income using the effective interest method in accordance with IAS 18. In addition, if the entity retains any liabilities after the disposal, it recognizes those liabilities in accordance with IAS 37.

9.51 When an investment property is impaired, lost, or given up, and the entity expects to receive third party compensation, such as a credit enhancement, insurance recoveries, or recoveries from a guarantor, the entity recognizes that compensation as a receivable. An entity separately accounts for claims or payments from third party compensation related to investment property impairments or losses, as well as the subsequent construction or purchase of a replacement investment property, as individual economic events, as follows:

- The costs of restoring, purchasing, or constructing the replacement, and the retirement or disposal of the investment property, is accounted for in accordance with paragraphs 20–29 and 66–71 of IAS 40, respectively.
- Impairments are recognized in accordance with IAS 36.

- Third party compensation receivable from the impaired, lost, or given up investment property is recognized in the profit or loss.

Disclosure

9.52 IAS 40 requires a number of disclosures in addition to those required by IAS 17 for lease transactions and arrangements within its scope. Refer to chapter 7 of this book and IAS 17 for additional guidance on the disclosures required for lease arrangements.

9.53 IAS 40 requires an entity to disclose the following information:

- Whether the entity applies the cost or fair value model
- If fair value model is used, whether and under what circumstances property interests held under operating leases are classified and accounted for as investment property
- When classification is difficult, the criteria used to distinguish investment property from owner-occupied properties and from property held for sale in the ordinary course of business
- Extent to which the fair value of investment property is based on a valuation by independent valuation professional, with recognized credentials and recent experience, or the fact that no such valuation was done
- Amounts recognized in profit or loss, including rental income; direct operating expenses (for example, repairs and maintenance) that are generating and not generating rental income; and the cumulative change in fair value recognized in profit or loss on sales between pools of assets in which the cost model is used in a pool in which the fair value model is used
- If there are restrictions on the investment property's realizability or the remittance of income or proceeds from their disposal and, if available, their amounts
- Contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance, or enhancements

Fair Value Model

9.54 When an entity applies the fair value model, it should, in addition to disclosing the items listed previously, provide a reconciliation of the beginning and ending carrying amounts of investment properties, disclosing the following:

- Additions that disaggregate individual property acquisitions from expenditures on existing properties recognized in the investment property's carrying amount
- Additions due to business combinations
- Assets classified as held for sale or as part of a disposal group classified as held for sale in accordance with IFRS 5
- Net gains or losses from fair value adjustments
- Net foreign exchange differences
- Transfers to or from inventory or owner-occupied property
- Other changes

9.55 Paragraph 77 of IAS 40 states that when an entity significantly adjusts a valuation obtained for investment property for the purpose of the financial statements, the entity should disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, separately showing the aggregate amount of any recognized lease obligations that the entity added back, and any other significant adjustments.

9.56 In the exceptional case that fair value can no longer be measured reliably and the cost model is used, an entity should present information about that property separately in the relevant reconciliation disclosure. The entity should also provide a description of the property and the circumstances that led to the determination that fair value was not reliable and, if possible, the range of estimates within which fair value is highly likely to lie. If that investment property was disposed of, the entity should disclose the fact that it could not be carried at fair value, the amount of its carrying value at the time of sale, and the gain or loss recognized.

Cost Model

9.57 For investment properties held under the cost model, an entity should provide the same disclosures described in paragraph 9.53 of this chapter, in addition to the following:

- The method of depreciation used and the rate of depreciation or useful life of the investment property.
- The gross carrying amount of the investment property and the accumulated depreciation, aggregated with any accumulated impairment losses, at the beginning and the end of the period.
- A reconciliation of the investment property's carrying amount at the beginning and end of the period including the following:
  - Additions that result in the separate disclose of additions from acquisitions from subsequent expenditures recognized as an asset.
  - Additions that result from acquisitions through business combinations. For additional business combination guidance, refer to chapter 16 of this book.
  - Assets classified as held for sale or included in a disposal group classified as held for sale, in accordance with the guidance found in IFRS 5, or other disposals. For additional guidance relating to IFRS 5, refer to chapter 18, "Noncurrent Assets Held for Sale and Discontinued Operations," of this book.
  - Depreciation.
  - The amount of increases or decreases that result from revaluations and impairment losses recognized or reversed in accordance with IAS 36. For additional guidance describing the impairment of assets, refer to chapter 6 of this book.
  - The net exchange differences that arise on the translation of the financial statements into a different presentation currency and on translation of a foreign operation into the presentation currency of the reporting entity.
  - Transfers to and from inventory and owner-occupied property.
  - Other charges.
- The fair value of the investment property. In the rare case that the entity could not reliably determine fair value, it should disclose the following:
  - A description of the investment property.
  - An explanation of why fair value cannot be determined reliably, and the range of estimates within which the fair value is highly likely to be, if possible.

Chapter 10

Income Taxes

Overview

10.01 An entity, including parents, subsidiaries, associates, and joint arrangements, typically incurs and pays foreign and domestic income taxes based upon its taxable income or distribution to its investors. Tax liabilities and payments may also include other taxes, such as withholding taxes. Differences sometimes arise between the amounts of revenues and expenses reported in an entity's financial statements, prepared in accordance with International Financial Reporting Standards (IFRSs), and the revenues and expenses recognized in a jurisdiction in a given period for tax purposes.

10.02 This chapter addresses the current and future tax consequences of transactions and other events of the current period recognized in an entity's financial statements as well as the future recovery or settlement of the carrying amount of assets and liabilities, respectively, that are recognized in an entity's statement of financial position and give rise to deferred tax liabilities and assets. With limited exception, an entity should recognize deferred tax liabilities and assets if it is probable that recovery or settlement of the carrying amount of an asset or liability will make future tax payments larger or smaller, respectively, than if such recovery or settlement had no tax consequences. This means that if an entity recognizes a transaction or an event in profit or loss, it should also recognize the related tax effect in profit or loss; if the entity recognizes the transaction or event directly in equity or other comprehensive income, it recognizes the related tax effects in the same way.

10.03 This chapter describes the accounting treatment for the current and future tax consequences of transactions and events recognized in the financial statements, the recognition of deferred tax assets and liabilities, unused tax losses and tax credits, and the presentation and disclosure of income taxes in an entity's financial statements.

Summary of Selective Accounting Guidance

10.04 International Accounting Standard (IAS) 12, *Income Taxes*, is the primary literature that prescribes the accounting for income taxes. The guidance in Standing Interpretations Committee (SIC) 21, *Income Taxes—Recovery of Revalued Non-Depreciable Assets*, describes the treatment of a deferred tax liability or asset that arises from the revaluation of a nondepreciable assets. SIC 25, *Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders*, addresses the accounting for the tax consequences of a change in an entity's tax status or that of its shareholders.

Scope and Scope Exceptions

10.05 The scope of this chapter and IAS 12 applies to the accounting treatment for all domestic and foreign income taxes that are based on taxable profits, including other taxes such as, but not limited to, withholding taxes payable by a subsidiary, an associate, or joint arrangement on distributions to the reporting entity.

10.06 IAS 12 also addresses the accounting for income tax temporary differences that arise from investment tax credits or governmental grants. However, IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, applies to the accounting treatment for governmental grants. Refer to chapter 12, "Accounting for Governmental Grants and Disclosure of Governmental Assistance," of this book for a detailed discussion of the accounting for governmental grants.

Recognition

10.07 Rules and regulations establish taxation authorities and tax jurisdictions to determine how an entity calculates taxable profit or loss for a period. Taxable profit is the basis for which income tax is payable.

10.08 Tax expense or tax income is comprised of current tax expense or current tax income and deferred tax expense or deferred tax income. Tax expense is based on profit or loss before income taxes on the entity's statement of profit or loss and other comprehensive income. Elements of other comprehensive income may also have tax consequences.

Tax Base

10.09 The *tax base* of an asset or liability is the amount attributed to that asset or liability for tax purposes. The tax base of an asset or liability may be equal to, but is distinct from, the carrying value of that asset or liability for financial reporting purposes. Accounting for the difference between an asset's or liability's tax base and carrying value is an essential element when accounting for income taxes under IAS 12. This difference may give rise to a temporary difference that may be either taxable or deductible.

10.10 A *taxable temporary difference* results in taxable amounts when determining taxable profit or loss of future periods when the carrying amount of the asset or liability is recovered or settled. A *deductible temporary difference* results in deductible amounts when determining taxable profit or loss of future periods when the carrying amount of the asset or liability is recovered or settled.

10.11 An entity determines the tax base of an asset or a liability as follows:

- The tax base of an asset is the amount that will be deductible for tax purposes against the taxable economic benefits that will flow to the entity when it recovers the asset's carrying amount. If the economic benefits are not taxable, the carrying amount and the tax base of the asset are equal.
- The tax base of a liability is its carrying value, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

10.12 When a tax base of an asset or liability is not immediately apparent, an entity should consider whether a tax consequence would result from the recovery or settlement of the carrying amount of an asset or liability. An entity determines the appropriate tax base for assets and liabilities included in the consolidated financial statements from the consolidated tax returns filed in the tax jurisdiction. In tax jurisdictions where the entity does not file a consolidated tax return, it determines the tax base using the tax returns of each entity in the group.

10.13 Items that the entity has not recognized as assets or liabilities may have a tax base. This circumstance can arise when the entity recognizes an expense in an accounting profit, but tax regulations do not permit the entity to deduct the amount of the expense in determining taxable profit or tax loss in the current period, but permits the deduction in future periods.

10.14 See for the following examples of how a manufacturer determines a tax base for an asset and a liability.

For an Asset

Example A—A machine costs CU 100. For tax purposes, the entity has recorded a deduction for depreciation of CU 30 to date and will deduct the remaining cost of CU 70 in future periods. Both the revenue generated by the machine and any gain or loss on disposal will be taxable or deductible, respectively. Therefore, the tax base of the machine is CU 70.

Example B—Dividends receivable from a subsidiary have a carrying value of CU 200. The dividends are not taxable. In substance, the entire carrying value is deductible for tax purposes because it is not taxable (not included in taxable income). Therefore, the tax base of the dividends receivable is CU 200.

For a Liability

Example A—Current liabilities include accrued expenses with a carrying amount of CU 300, which the entity has already deducted for tax purposes. Therefore, the tax base of the accrued expenses is CU 300, equal to the carrying value.

Example B—Current liabilities include accrued penalties and fines that have a carrying value of CU 40 and are not deductible for tax purposes. Therefore, the tax base of the accrued penalties and fines is zero because the difference between the carrying value and the tax base is permanent, not temporary. The entity does not recognize a deferred tax asset due to the lack of future deductibility of the penalties and fines.

Tax Base When an Item Is Not an Asset or a Liability

Example A—Manufacturer incurs a cost of CU 400 for product research, which is expensed in the current period when it determines accounting profit. Therefore, the research expense has a carrying value of zero (no asset recognized). If the tax regulations do not permit the entity to deduct these research costs in same period, but do permit a deduction in a future period, the tax base of the research expense is CU 400.

10.15 Refer to the illustrative examples that accompany IAS 12 for examples of circumstances that give rise to taxable and deductible temporary differences, as well as computational illustrations.

Current Tax Liabilities and Current Tax Assets

10.16 In most jurisdictions, the amount of revenues and expenses an entity recognizes in a given period for tax purposes generally results in a current tax amount for the period that is either payable if there were taxable profits, or recoverable if there were tax losses.

10.17 When a current tax that relates to a current or prior period is unpaid at the end of the reporting period, the entity recognizes a liability. If an excess amount of tax was paid during a current or prior period, the entity generally recognizes the excess as an asset. Recognition of both assets and liabilities depends upon meeting the recognition criteria in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*.

10.18 If a tax loss occurs and the tax authority or jurisdiction allows the tax loss to be carried back to recover current tax from a previous period, the entity recognizes the benefit as an asset. The entity recognizes this asset in the period that the tax loss occurred because it is probable that the benefit will flow to the entity and the entity can measure the asset reliably.

Deferred Tax Liabilities and Deferred Tax Assets

10.19 Temporary differences sometimes arise between the accounting profit or loss, determined by the amount of revenues and expenses reported in an entity's financial statements prepared in accordance with IFRSs, and revenues and expenses recognized by taxing authorities. These temporary differences result in deferred tax amounts that are payable or recoverable in future periods.

10.20 Paragraph 5 of IAS 12 defines *deferred tax liabilities* as the amounts of income taxes payable in future periods in respect of taxable temporary differences. *Deferred tax assets* are defined as the amounts of income taxes recoverable in future periods in respect of

- deductible temporary differences;
- carryforward of unused tax losses; and
- carryforward of unused tax credits.

10.21 The accounting for deferred taxes that arise from these temporary differences required by IAS 12 is commonly referred to as the balance sheet liability method or balance sheet approach to measuring deferred tax liabilities and assets. The balance sheet approach focuses on differences in the tax base and carrying values of assets and liabilities that give rise to temporary differences. IAS 12 prohibits the use of the income statement approach, which focuses on profit or loss before income taxes on the entity's statement of profit or loss and other comprehensive income to account for timing differences between the recognition of tax expense and tax payable or receivable.

Taxable Temporary Differences

10.22 All taxable temporary differences are recognized as deferred tax liabilities except for the following:

- When the taxable temporary difference arises from the initial recognition of either goodwill, or in a transaction with assets or liabilities, that is not deemed a business combination

- At the time of the transaction, the difference does not have an effect on the entity's accounting profit, taxable profit, or tax loss

10.23 The exceptions listed previously may not apply, depending on the taxing jurisdiction, to taxable temporary differences that arise from the initial recognition of an equity component, separately from the liability component, of a compound financial instrument, in accordance with IAS 32, *Financial Instruments: Presentation*.

10.24 Refer to paragraphs 10.40–.45 for a discussion of temporary differences that arise from investments in subsidiaries, associates, and interests in joint arrangements.

10.25 A taxable temporary difference arises when an asset's carrying amount exceeds its tax base, resulting in a deferred tax liability and an obligation to pay incomes taxes in future periods. When the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse.

10.26 Taxable temporary differences sometimes arise when the entity recognizes income or expenses in accounting profit in a certain period, but records these amounts for tax purposes in a different period.

10.27 Examples of these temporary differences, as listed in paragraph 17 of IAS 12, include the following:

- When the entity includes interest income in accounting profit on a proportional basis, but the interest income is included in taxable profit when cash is collected. The tax base of any receivable recognized in the statement of financial position with respect to such revenue is nil because the revenues do not affect taxable profit until cash is collected.
- The entity uses an acceptable accelerated depreciation method for an asset for tax purposes, which results in more rapid depreciation than the depreciation method used for that same asset for accounting purposes. Under this fact pattern, the entity would recognize a deferred tax liability. If the entity recognized accounting depreciation more rapidly than tax depreciation, the entity would recognize a deferred tax asset, subject to the availability of expected taxable profit in the future.
- The entity may capitalize development costs and amortize them over future periods for accounting purposes. However, the entity deducts these costs from taxable profit in the period in which they are incurred. Such development costs have a tax base of zero because they have already been deducted from taxable profit when they are amortized in the future. The temporary difference is the difference between the carrying amount of the development costs at a point in time and the tax base of zero.

10.28 Other types of taxable temporary differences include the following:

- In business combinations when the acquired identifiable assets and liabilities assumed are recognized at the date of acquisition at their fair value for accounting purposes, but their value for taxable profit or loss carries over their original or different tax base. With limited exceptions, the difference created affects goodwill and results in a deferred tax liability or asset.
- In some jurisdictions, entities will revalue certain assets or carry them at fair value for accounting purposes, but do not make a similar adjustment to the tax base for tax purposes. The difference between the assets' carrying amount and their tax bases is a temporary difference and gives rise to a deferred tax liability or asset even in the following circumstances:
  - The entity has no intention to dispose of the asset.
  - The entity disposes of the asset and invests the proceeds from the disposal in a similar asset and defers any capital gains tax on the disposal.

  Refer to IAS 38, *Intangible Assets*; IAS 16, *Property, Plant and Equipment*; and chapters 4, "Intangible Assets," and 5, "Property, Plant, and Equipment," of this book for additional guidance regarding intangible assets or property, plant, or equipment, respectively, accounted for using the revaluation model. Refer to IAS 40, *Investment Property*, and chapter 9, "Investment Property," in this book for additional guidance on investment property measured at fair value.

- When a reduction in the amount of goodwill (for example, from an impairment loss) that arose in a business combination in accordance with IFRS 3, *Business Combinations*, is not deductible for tax purposes, the tax base of goodwill is zero and results in a taxable temporary difference. However, this taxable temporary difference arose from the initial recognition of goodwill and IAS 12 does not permit an entity to recognize a deferred tax liability in this case. The initial recognition of an asset or liability carrying amount may differ from its tax base, possibly giving rise to temporary differences. An example of this is when part or all of an asset's cost was not deductible for tax purposes, or if an entity received a government grant for the related asset that was deemed nontaxable.

10.29 An entity should account for temporary differences that arise from the initial recognition of an asset or a liability as follows:

- Temporary differences that arise from a business combination and that an entity recognizes with limited exceptions may affect goodwill or a bargain purchase gain and will result in a deferred tax liability or asset.
- The transaction affects taxable profit or accounting profit and the entity recognizes a deferred tax asset or liability along with a deferred tax expense or income in profit or loss.
- In addition to the exception for the initial recognition of goodwill in a business combination described previously, paragraph 15 of IAS 12 does not permit the recognition of taxable temporary differences as deferred tax liabilities when they arise from the initial recognition of a transaction with assets or liabilities that are not deemed a business combination at the time of acquisition and the transaction does not have an effect on the entity's accounting or taxable profit or loss. Otherwise, an entity recognizes taxable temporary differences from the acquisition that do affect accounting profit or taxable profit or loss as deferred tax assets or liabilities.
- For taxable temporary differences that arise from investments in subsidiaries, associates, and interests in joint arrangements, refer to paragraphs 10.40–.45 in this chapter.

Deductible Temporary Differences

10.30 An entity should recognize a deferred tax asset that relates to all deductible temporary differences when it is probable that the deferred tax asset can be utilized against available taxable profits. However, IAS 12 does not permit an entity to recognize a deferred tax asset that originated from an initial recognition of an asset or liability that was not from a business combination and, at the time of the transaction, did not have an effect on the accounting or taxable profit or loss. Refer to paragraphs 10.40–.45 for a discussion of deductible temporary differences and deferred tax assets associated with investments in subsidiaries, associates, and interests in joint arrangements.

10.31 When determining whether it is probable that an entity can use available taxable profits against a deductible temporary difference, the entity should determine whether it has sufficient taxable temporary differences related to the same tax authority and the same taxable entity that are expected to reverse

- in the same period that it expects deductible temporary differences to reverse, or
- in periods into which a tax loss can be carried back or forward that arises from that deferred tax asset.

Based upon this fact pattern, the period in which the deductible temporary differences arose would be the same period that the deferred tax asset is recognized.

10.32 When it is determined that the entity does not have sufficient taxable temporary difference relating to the same taxation authority or jurisdiction and the same taxable entity, it recognizes a deferred tax asset only to the extent that

- it is probable that the entity will have
  - sufficient taxable profits relating to the same tax authority or jurisdiction and the same taxable entity

  - in the same period as it expects the reversal of the deductible temporary difference from that deferred tax asset, or
  - in periods into which a tax loss arising from that deferred tax asset can be carried back or forward.
- the entity takes actions that would increase or create taxable income for the appropriate periods through tax planning opportunities, so that it can use the tax loss or tax credit carryforwards before they expire.

10.33 Depending upon the tax jurisdiction, the following examples of tax planning opportunities may increase or create taxable profits:

- Selling an asset that generates nontaxable income, such as a government bond, and subsequently purchasing a different investment that gives rise to taxable income
- Making an election to have interest income taxed on either a received or receivable basis
- Deferring, if possible, certain deductions into future periods, thus creating more current taxable profit

10.34 If an asset's carrying amount is less than its tax base, the difference creates a deferred tax asset to the extent that the entity can recover previously paid income taxes in future periods. An example of this is when an entity deducts the cost of retirement benefits when determining accounting profit, but those contributions have not been paid to the fund. The entity will only deduct these costs for tax purposes when it makes a contribution to the fund. This situation gives rise to a deferred tax asset that would be recovered in future periods when the contribution or retirement benefits are paid.

Unused Tax Losses and Tax Credit

10.35 To the extent that it is probable that future taxable profits will be available, an entity will recognize deferred tax assets for the carryforward of unused tax losses and tax credits, provided that the deferred tax assets arose from deductible temporary differences. If an entity experiences a history of recent losses, there is a strong possibility that the entity will not be able to use accumulated unused tax losses and tax credits.

10.36 In order to determine whether it is probable that the entity will have sufficient future taxable profits, an entity considers the following issues described in paragraph 36 of IAS 12:

- Whether the entity has sufficient taxable temporary differences that relate to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilized before they expire
- Whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire
- Whether the unused tax losses result from identifiable causes that are unlikely to recur
- Whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilized

10.37 For example, a tax planning opportunity may exist when an entity that has a large tax loss carryforward that may easily be realized despite additional operating losses if it sells an appreciated piece of land at a large taxable gain.

10.38 When it is not probable that an entity will have available future taxable profits that allow for the utilization of the unused tax losses and credits, the entity should not recognize a deferred tax asset.

Unrecognized Deferred Tax Assets

10.39 Previously unrecognized deferred tax assets are reassessed at the end of each reporting period to assess if these assets can be recognized because it is not probable that the entity will have sufficient future taxable profits. Some future events that would cause an entity to reassess their recognition include the following:

- The ability to generate future taxable profits due to an improvement in trading conditions; and
- Reassessing deferred tax assets that arose from a business combination either at or subsequent to the acquisition date.

Investments in Subsidiaries, Associates, and Joint Venture Arrangements

10.40 The carrying amount of investments in subsidiaries, associates, and joint arrangement interests, which includes goodwill in the carrying amount, sometimes will differ from their tax base (cost of the investment) and give rise to temporary differences. Examples of circumstances in which this may occur include the following:

- The existence of undistributed profits from these investments
- When the entity's parent and its subsidiary are based in different countries and there are changes in foreign exchange rates
- When an investment in an associate's carrying amount has been reduced to a recoverable amount

10.41 With respect to foreign exchange rates, in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, an entity will measure its nonmonetary assets and liabilities in its functional currency. If taxable profits or losses are determined in different currencies, and changes in the exchange rates give rise to temporary differences, then deferred tax liabilities or assets may be recognized. Refer to chapter 22, "Foreign Currency Translation," of this book for additional guidance regarding changes in foreign exchange rates.

10.42 Temporary differences associated with these investments in the entity's parent-only separate financial statements may differ from those in its consolidated financial statements if the parent-only financial statements carry the investments at cost or revalued amounts.

10.43 The entity recognizes all temporary differences that arise from these investments as deferred tax liabilities, unless an entity satisfies both of the following conditions:

- The parent, investor, or joint venturer or operator is able to control the timing of reversal of these temporary differences; for example, having the ability to control a subsidiary's dividend policy.
- It is not probable that the temporary differences will reverse in the foreseeable future.

10.44 When an entity does not control an investment, it generally does not have the ability to set the dividend policy in the absence of any separate agreements to the contrary. Therefore, in the absence of an agreement that the associate will not distribute its profits in the foreseeable future, an investor should recognize a deferred tax liability that arises from taxable temporary differences associated with its investment in that associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate. However, an investor can determine whether the amount will equal or exceed a minimum amount. In such cases, the investor should measure the deferred tax liability at this minimum amount.

10.45 All deductible temporary differences that arise from these investments are recognized by the entity as deferred tax assets, only to the extent that the following are probable:

- Temporary differences will reverse in the foreseeable future.
- Future taxable profits will be available so the entity can use the deferred tax asset.

Measurement

10.46 An entity should generally measure both current and deferred tax assets and liabilities based on enacted tax laws and rates, but may sometimes measure these assets and liabilities using a substantively enacted tax law and rates by the end of the reporting period, when a government or taxing jurisdiction announces the substantive effect of the actual enactment.

Current Tax Assets and Liabilities

10.47 An entity measures current tax assets and liabilities at the amount it expects to recover or pay for the current and prior period from the taxing jurisdiction using the tax laws or rates that have been enacted, or substantively enacted by the end of the reporting period.

Deferred Tax Assets and Liabilities

10.48 An entity measures deferred tax assets and liabilities at an amount based on the tax rates that have been enacted or substantively enacted by the end of the reporting period that will apply to the period it expects to realize the asset or settle the liability. Varying tax rates sometimes apply to different levels of taxable income. Under these circumstances, the entity uses the average tax rates expected to apply to the taxable profits or losses for the periods the temporary differences are expected to reverse.

10.49 The way in which assets are recovered or liabilities settled may affect the applicable tax rate, tax base, or both. If this occurs, the entity should measure the deferred tax assets and liabilities using the tax rates and tax bases that are consistent with the way in which recovery or settlement are expected to occur.

10.50 When part or all of an entity's net profits or retained earnings are paid out as dividends to shareholders and, consequently, income taxes payable or refundable are at a higher or lower rate, the entity measures current and deferred tax assets and liabilities at the applicable tax rate for the undistributed profits. When the entity recognizes a liability to pay the dividends, it also recognizes the income tax consequences associated with the dividends, because the income tax consequences are more directly related to past transactions or events, not the timing of the distribution.

10.51 An entity measures deferred tax assets and liabilities that arise from revaluing nondepreciable assets based on the assumption that the entity will recover the asset's carrying value through sale, regardless of the basis of measuring the carrying value of that asset. If the tax law specifies that a different tax rate should be applied to taxable income from the sale than to taxable income from use of the asset, the entity uses the tax rate applicable to a sale to determine the deferred tax asset or liability.

10.52 IAS 12 does not permit discounting future amounts to measure deferred tax assets and liabilities, even when the carrying amounts of the related asset or liability were determined on a discounted basis; for example, deferred tax assets or liabilities related to obligations that arise from retirement benefits.

10.53 An entity reviews the carrying value of a deferred tax asset at the end of each reporting period and reduces the carrying value to the extent that it is no longer probable that there will be sufficient taxable profits to use part or all of the deferred tax asset benefits. When it becomes probable that the entity can use the deferred tax benefits, the entity should reverse the reduction.

Deferred Taxes That Arise From a Business Combination

10.54 When temporary differences arise in business combinations, an entity may recognize deferred tax assets and liabilities at the date of acquisition. Recognition of deferred tax assets and liabilities at the acquisition date affects amounts initially recognized for goodwill or bargain purchase gains. However, paragraph 15a of IAS 12 states that an entity does not recognize deferred tax liabilities that arise from the initial recognition of goodwill.

10.55 The probability of being able to recognize a previously unrecognized deferred tax asset that existed prior to acquisition may change as a result of a business combination. The acquirer may determine that it is now probable, postacquisition, to recognize an existing unrecognized deferred tax asset, such as unused tax losses or tax credits.

10.56 When an entity determines it is no longer probable that it can use a recognized deferred tax asset as a result of a business combination, it should recognize the change in the deferred tax asset in the same period the acquisition occurred. The entity should recognize this change separately from its accounting for the business combination. Therefore, this change has no effect on the measurement of goodwill or a bargain purchase gain.

10.57 An entity may subsequently recognize income tax loss carryforwards or other deferred tax assets acquired in a business combination that might not have qualified for separate recognition initially. In accordance with paragraph 68 of IAS 12, an entity should recognize acquired deferred tax benefits that it realizes after the business combination as follows:

- The entity should apply any acquired deferred tax benefits recognized within the measurement period that result from new information about facts and circumstances that existed at the acquisition date to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, the entity recognizes any remaining deferred tax benefits in profit or loss.
- The entity recognizes all other acquired deferred tax benefits realized in profit or loss or outside profit or loss if required by IAS 12.

Current and Deferred Tax That Arise From Share-Based Payment Transactions

10.58 An entity sometimes receives a deduction when determining taxable profits or losses related to employee compensation paid in shares or options or other types of equity instruments. These deductions may arise in later accounting periods and may differ from related cumulative compensation expense. The difference between the nil carrying amount of the employee services received and its tax base results in a deductible temporary difference giving rise to a deferred tax asset. If the deduction the tax jurisdiction will permit is unknown, the entity should estimate the tax deduction based upon the information available at the end of the period.

10.59 When a difference arises between the cumulative remuneration expense recorded in the accounting period and the amount of current or future tax deduction, the entity recognizes current and deferred tax in profit or loss as income or expense for the period, except from

a. a transaction or event that causes recognition to occur outside of profit or loss, or

b. a business combination.

10.60 When the difference in the amount of current or future tax deductions exceeds the cumulative compensation expense recorded in the accounting period, it is a strong indication that the expense also includes an equity item. Under these circumstances, the entity recognizes the current or deferred tax associated with this difference in equity.

10.61 Refer to chapter 13, "Share-Based Payment Transactions," of this book for additional guidance regarding accounting for share-based payments.

Initial Recognition

10.62 An entity recognizes current and deferred taxes in profit or loss for the period as tax income or expenses, respectively, unless they were associated with the following:

- A transaction or event that caused recognition to occur outside of profit or loss in either other comprehensive income or directly in equity in the same or different period
- A business combination

10.63 In these circumstances, the entity recognizes current and deferred taxes, in the same or different periods, outside of profit or loss. Examples of the types of transactions or events that IFRSs require or permit an entity to recognize outside of profit or loss, either in other comprehensive income or directly in equity, include the following:

- The revaluation of the carrying amount of property plant and equipment. See chapter 5 of this book and IAS 16 for additional information.
- The translation of exchange rate differences of foreign operations. See chapter 22 of this book and IAS 21 for additional information.
- When changes in accounting policies are applied retrospectively or if there is a correction of an error. Refer to chapter 30 in this book and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, for additional information.
- The initial recognition of a compound financial instrument equity component.

10.64 When it is difficult to determine current and deferred tax amounts that relate to items recognized outside of profit and loss, an entity should use a reasonable pro rata allocation or other appropriate allocation method.

10.65 An entity recognizes the tax consequences of a recognized dividend from part or all of net profits or retained earnings paid to shareholders in profit or loss for that period, unless the exceptions in paragraph 10.62 apply. If the tax jurisdiction requires the entity to pay a portion of the dividend to the tax authority as tax on behalf of shareholders, commonly referred to as *withholding taxes*, the entity recognizes the portion of the dividend paid to the tax authority in equity.

10.66 When there is a change in the tax status of an entity or its shareholders (for example, when a privately held entity is publicly listed), the entity recognizes any increase or decrease in current or deferred tax consequences caused by the change in profit or loss for the period, except when they relate to transactions or events in the same period or different period that would result in a direct charge or credit to an amount that was recognized outside of profit or loss and recognized in equity or other comprehensive income.

Subsequent Measurement

10.67 Deferred tax asset and liability carrying amounts may change, regardless of whether the related temporary differences also change. When this occurs, the entity recognizes the change to the deferred tax asset or liability in profit or loss, unless it was previously recognized outside of profit or loss. These changes may occur when

- there is a change in tax laws or rates.
- the entity reassessed a deferred tax asset's recoverability, resulting in changes to the carrying value of that asset, or if there is a change in the expected manner in which the asset will be recovered.

Presentation

Tax Assets and Tax Liabilities

Current Tax Assets and Liabilities

10.68 An entity may offset current tax assets and liabilities (use a net presentation), providing

- there is a legally enforceable right to offset the amounts recognized.
- the entity intends to realize the asset and settle the liability at the same time, or settle the asset and liability on a net basis.

10.69 An entity normally would have a legal right to offset a current tax asset and liability when they are levied by the same tax authority.

10.70 In order to offset the current tax assets and liabilities of an entity in a consolidated group against those of another entity in the same group, there must be a legally enforceable right to offset the amounts recognized. The entity can realize or settle the asset and liability at the same time or on a net basis.

Deferred Tax Assets and Liabilities

10.71 Deferred tax assets and liabilities may be offset only if

- there is a legally enforceable right to offset the current tax assets and liabilities.
- the deferred tax assets and liabilities relate to the same tax jurisdiction that levied the income taxes on either the same taxable entity or, if they relate to different entities, the entity intends to simultaneously realize and settle them in each future period in which it expects to realize or settle significant amounts of deferred tax assets and liabilities.

10.72 Generally, an entity is not required to prepare a detailed schedule that presents the timing and reversal of each temporary difference. However, for the rare circumstance that an entity intends to net settle some periods but not others, a detailed schedule may be required even if the entity has a legally enforceable right to settle net.

Tax Expense

10.73 The statement of profit or loss and other comprehensive income should present tax income or expense related to profit or loss from ordinary activities. For entities that present components of profit or loss in a separate income statement, it presents the tax income or expense related to profit or loss from ordinary activities in that separate statement.

10.74 In accordance with IAS 21, an entity should present certain deferred foreign tax assets or liabilities containing exchange differences in the statement of profit or loss and other comprehensive income. If it is most useful to financial statement users, these amounts may be classified as deferred tax income or expense.

10.75 Refer to the illustrative examples that accompany IAS 12 for presentation illustrations for tax expense.

Disclosure

10.76 IAS 12 requires entities to disclose income tax expense separately by major components, which may include the following:

- Current tax income or expense
- Any adjustments in the period for current tax of other periods
- Deferred tax income or expense from origination or reversal of temporary differences
- Deferred tax income or expense from changes in tax rates or laws
- Benefits from previously unrecognized or recognized tax loss or tax credit carryforwards or temporary differences from other periods used to reduce current or deferred tax expense
- Deferred tax expense (income) from write-downs (or reversals) of deferred tax assets
- Tax income or expenses that result from a change in accounting policy or errors because they cannot be accounted for retrospectively
- Current and deferred income tax income or expense that relate to items charged to other comprehensive income and directly to equity

10.77 Entities should explain the relationship between tax income or expense and accounting profit by disclosing either or both of the following reconciliations:

- Amounts of reported income tax income or expense to the expected amount based on applicable (statutory) tax rates(s)
- Average effective tax rate to the applicable tax rate(s)

10.78 In both cases, entities should disclose the basis on which the applicable tax rate was computed. Entities should explain any changes in the applicable tax rate(s) from the previous period.

10.79 Entities should disclose the aggregate amount of temporary differences that have not been recognized as deferred tax liabilities relating to investments in subsidiaries, associates, and interest in joint arrangements.

10.80 For each type of unused tax loss and unused tax credit and each type of temporary difference, the entity should disclose the amount of

- the deferred tax assets and liabilities recognized, for each period presented in the statement of financial position.
- the deferred tax income or expense recognized in the profit or loss, if the changes in the amounts recognized in the statement of financial position are not apparent and need clarification.

10.81 With respect to discontinued operations, entities should disclose the tax expense or income from gains or losses on discontinuance and profit or loss of discontinued operations for all periods presented.

10.82 If dividends were declared or proposed to shareholders before the financial statements were authorized for issuance, and have not been recognized as a liability, the amount of income tax consequence should be disclosed. In addition, the nature and amount of potential income tax consequences that would result from the payment of shareholder dividends should be disclosed as practicably determinable and whether there are any that are not determinable.

10.83 If a recognized pre-acquisition deferred tax asset amount has changed in a business combination, the entity should disclose the amount of that change and, if the acquired deferred tax asset was recognized subsequent to the acquisition date, a description of the event or change in circumstances causing its recognition should be disclosed.

10.84 The amount and nature of evidence of a recognized deferred tax asset should be disclosed when

- the deferred tax asset's utilization is dependent upon future taxable profits that exceed the profits arising from its reversal of the existing temporary differences.
- a loss was suffered in the current or other periods in the taxing jurisdiction in which the deferred asset relates.

Chapter 11

Revenue

Overview

11.01 The International Accounting Standards Board's (IASB's) *Conceptual Framework for Financial Reporting* (conceptual framework) describes the *financial statement element income* as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets, or reductions of liabilities, that result in an increase in equity, other than increases in equity related to contributions by equity participants. Income includes both revenue and gains. The conceptual framework distinguishes revenue from other types of income and gains, reserving the term *revenue* for income that results from the entity's ordinary activities.

11.02 Gains also meet the definition of income but may or may not result from the entity's ordinary activities. Because gains represent increases in economic benefits, they are no different in nature from revenue and the conceptual framework does not consider gains a separate element of the financial statements.

11.03 Income also includes unrealized gains; for example, arising on the revaluation of financial assets or investment property held at fair value.

Summary of Selective Accounting Guidance

11.04 International Accounting Standard (IAS) 18, *Revenue*, establishes the accounting and disclosure requirements for revenue from the following transactions:

- Sale of goods
- Rendering of services
- Use by others of an entity's assets yielding interest, dividends, or royalties

11.05 Standing Interpretations Committee (SIC) 31, *Revenue—Barter Transactions Involving Advertising Services*, provides guidance for transactions accounted for under IAS 18 that result from an exchange of dissimilar advertising services. In accordance with IAS 18, an entity should not recognize revenue on an exchange of similar advertising services.

Author's Note: In January 2010, the IASB published for public comment an exposure draft, *Revenue from Contracts with Customers*. The proposed standard would replace IAS 18, IAS 11, *Construction Contracts*, and related interpretations. The core principle in the exposure draft is to recognize revenue so as to "depict the transfer of goods or services in an amount that reflects the consideration expected to be received in exchange for those goods or services." An entity would take five steps to apply this principle:

1. Identify the separate performance obligations.
2. Determine the transaction price for the contract(s).
3. Allocate the transaction price to the performance obligations.
4. Recognize revenue when the entity settles the performance obligations.
5. Identify the customer contract(s).

Overall, comment letters support the project's objective to create a single revenue recognition standard to be used across industries and capital markets. However, other comments resulted in redeliberation by the board on a number of issues including determining when transfer occurs for services, clarifying what constitutes a "distinct" performance obligation, handling of contract modifications, reducing complexity of the proposed approach to segmenting contracts, determining whether an entity should expense all contract acquisition costs, accruing "statutory" warranty costs, determining how to account for licenses, reducing complexity of measurements, and determining when to apply a test for an onerous contract.

(continued)

Because of the extent of the changes to the proposed standard, the board re-exposed the revised proposals in November 2011. Some of the changes to the original exposure draft include the board's decisions to

- add risks and rewards of ownership as an indicator of transfer of control of a good or service and eliminated customer-specific design or function as an indicator of control.
- revise the criteria for identifying separate performance obligations in three ways. First, the criteria specify when an entity should account for a bundle of highly interrelated goods or services as a single performance obligation. Second, the criteria require an entity to consider only whether it sells the good or service separately and not consider whether the good or service is sold by other entities. Third, the distinct profit margin criterion is eliminated.
- require an entity would recognize revenue at the amount of consideration to which it is entitles without including expectations of collectibility in that measurement.
- require an entity to present impairment losses related to contracts with customers as a separate line item adjacent to the revenue line item so that users could easily compare revenues and reductions of revenue arising from credit risk.
- amend the revenue recognition constraint to be reasonably assured and applied when consideration is variable and only to the cumulative amount of revenue. (The board clarified that this constraint is not quantitative but considers the quality of information used to estimate the amount of variable consideration to which the entity is entitled.)
- refine how an entity would apply the onerous performance obligation test by limiting the test to those performance obligations satisfied over a period of time longer than one year, and clarifying the measurement.
- affirm the disclosure requirements while acknowledging both their volume and usefulness to users of financial statements.

During the first half of 2012, the board began to deliberate these proposals based on the comments received on this exposure draft with a target date for issuing an International Financial Reporting Standard (IFRS) in 2013.

Scope

11.06 IAS 18 does not address the accounting for revenue or income generated by the following:

- Extraction of mineral ores
- Changes in value of current assets
- Assets covered by another IFRS

11.07 For example, IAS 18 does not apply to revenue arising from leases; dividends from equity-method investments; insurance contracts; change in fair value or disposal of financial instruments; agricultural produce; and biological assets. These topics are addressed by other IFRSs.

11.08 IAS 18 expands on the description of revenue in the conceptual framework, and defines *revenue* as the gross inflow of economic benefits during the period in the course of the entity's ordinary activity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. Revenue includes only gross inflows of economic benefits received or receivable by the entity on its own account. Amounts collected on behalf of third parties, such as taxes, are not economic benefits and do not result in an increase in equity. Therefore, an entity excludes these amounts from revenue.

Recognition and Measurement

Identifying the Transaction

11.09 Paragraph 13 of IAS 18 requires an entity to apply the revenue recognition separately to each transaction and, in some circumstances, apply the criteria to the separately identifiable components of a single transaction to reflect the substance of the transaction. Conversely, the standard also requires an entity to apply the criteria to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the entire series of transactions. This requirement is generally referred to as segmenting and combining transactions to arrive at the substance of the arrangement. Because there is limited guidance on segmenting and combining in IAS 18, the entity would normally look to any guidance in other IFRSs on this issue. Therefore, entities would consider the applicability of the guidance on segmenting and combining in IAS 11.

Measurement

11.10 An entity measures revenue at the fair value of the consideration received or receivable. When determining fair value, the entity should take into account any trade discounts, settlement discounts, or volume rebates.

11.11 When a transaction is, effectively, a financing arrangement, IAS 18 requires an entity to determine fair value by discounting future cash flows from the transaction using an imputed interest rate. The *imputed rate of interest* is the more clearly determinable of either the prevailing rate on similar instruments by issuers with similar credit ratings, or the rate that discounts the nominal amount of the instrument to the current cash sales price of the goods or services provided. An entity should recognize the difference between the present value and the nominal amount as interest revenue, in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*.

> ***Author's Note:*** The IASB issued IFRS 9, *Financial Instruments*, in November 2009 and again in October 2010 as a replacement to IAS 39. IFRS 9 is effective for annual periods beginning on or after January 1, 2015. At that time, the reference in IAS 18 to IAS 39 will be replaced by a reference to IFRS 9. The requirement will not change.

11.12 When an entity is the principal in a revenue transaction, it should recognize revenue at the full amount of the consideration received or receivable and also recognize the associated cost of sales. An entity that acts as an agent only recognizes revenue for the amount of the commission or fee received or receivable it will retain from the transaction.

Sales of Goods

11.13 In order to recognize revenue on a sale of goods, an entity should satisfy the following criteria in addition to the probability and measurement reliability criteria discussed previously:

- Probability criteria. It is probable that future economic benefits associated with the transaction will flow to the entity.
- Measurement reliability criteria. The entity can measure the amount of revenue and amount of costs incurred or to be incurred in respect of the transaction, if any, reliably.
- Risks and rewards criteria. The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
- Control criteria. The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

11.14 Assessing whether the risks and rewards and control criteria are met requires the entity to examine the circumstances of the transaction. In most cases (for example, retail sales), the entity will meet the risks and rewards criteria when it delivers the goods and legal title passes to the buyer. In other cases, the entity may retain significant risks and rewards of ownership. The seller may not meet the risks and rewards criteria when it retains an obligation for unsatisfactory performance not covered by ordinary warranty provisions, or when receipt of consideration from a sale may be contingent on the buyer reselling the goods. In such cases, the entity should recognize revenue only when the risks and rewards of ownership finally pass to the buyer. When only an insignificant risk is retained, the entity recognizes both a sale and revenue. Examples of these circumstances are when the seller retains legal title to ensure payment by the buyer, or an offer of a refund when a buyer is not satisfied. The entity recognizes revenue and recognizes a liability for its estimate of returns or bad debts.

Exchanges of Goods or Services for Other Goods or Services

11.15 An entity may exchange goods and services for other goods or services. When the goods sold or services rendered are similar in nature or value to those received, the entity should not recognize revenue on the exchange transaction. When the goods sold or services rendered are dissimilar from those received, the entity should recognize revenue measured at the fair value of the goods or services received, adjusted by any cash or cash equivalents transferred. When the entity cannot measure the fair value of goods or services received reliably, it should recognize revenue at the fair value of the goods sold or services rendered, adjusted by any cash or cash equivalent transferred.

11.16 SIC 31 specifically addresses the accounting for bartering of advertising services. When an entity enters into a barter transaction, it should recognize revenue only when it can determine the fair value by reference to nonbarter transactions that, among other characteristics, involve advertising similar to the advertising in the barter transaction, occur frequently, involve cash or some other form of consideration that has a reliable fair value measurement, and do not involve the same counterparty as the barter transaction.

Rendering of Services

11.17 With respect to revenue generated by providing services, an entity should recognize revenue by reference to the stage of completion of the transaction, which is referred to as the percentage of completion method. An entity recognizes revenue when it meets the probability and measurement reliability criteria described in paragraph 11.13 for sale of goods and, at the end of the reporting period, it can also measure the stage of completion reliably.

11.18 With respect to measuring the stage of completion, IAS 18 does not require an entity to use a particular method. Use of surveys of work or services performed to date and costs incurred to date as a percentage of total expected costs are acceptable measurement methodologies. However, progress payments and advances received from customers often do not reflect, and are not considered reliable measures of, the services performed. Therefore, an entity should not use these cash flows to measure the stage of completion.

11.19 An entity is generally able to make reliable estimates of revenues, costs, and the stage of completion after the relevant parties have agreed to the terms of the arrangement. The terms of an arrangement include each party's enforceable rights, the consideration to be exchanged, and the manner and terms of settlement. The entity would need to have an effective internal financial budgeting and reporting system and should review and revise, when necessary, its estimates of revenues and services performed. Because estimates are a normal part of these transactions, the need for revisions does not necessarily mean the estimates are unreliable.

11.20 When an entity performs services by an indeterminate number of acts over a specified period of time, it should recognize revenue on a straight-line basis over the service period, unless there is evidence that some other method better represents the stage of completion of the transaction. In addition, when a specific act is much more significant than any other act, the entity should not recognize revenue until it performs that significant act.

11.21 Particularly in the early stages of a transaction that involves rendering of services, it may not be able to estimate the outcome of the transaction reliably, although it is probable that an entity will recover its costs. In these circumstances, the entity should recognize revenue only up to the amount of recoverable costs incurred. This is often referred to as the cost recovery method.

Interest, Royalties, and Dividend Revenue

11.22 An entity should recognize revenue from the use by others of assets yielding interest, dividends, or royalties only when it meets the probability and measurement reliability criteria described in section on the sale of goods. An entity should recognize revenue from these transactions as follows:

- Interest revenue using the effective interest method in accordance with IAS 39.
- Royalty revenue on the accrual basis, in accordance with the substance of the relevant agreement.
- Dividend revenue when an entity's shareholder rights to dividends are established.

Examples

11.23 See the following table for different transactions and events and the likely timing of revenue recognition for these transactions.

Revenue Transaction	*Expected Industry*	*Timing of Revenue Recognition*
Goods shipped subject to a right of return	Manufacturing, Consumer Products	When formally accepted or rejection period has lapsed.
Goods shipped subject to installation and inspection	Manufacturing, Aerospace, Computers	When installation and inspection is complete or on delivery if installation is simple.
Bill and hold—delivery is delayed but buyer takes title and accepts billing		When risk and rewards, control, and probability criteria are met.
Developed customized software	Software Development	Based on stage of completion, may include post-delivery services recognized as delivered.
Services—insurance and commissions	Insurance	Effective the commencement or renewal.
Customer loyalty awards	Airlines, Retail	International Financial Reporting Interpretations Committee 13, *Customer Loyalty Programmes*.

Presentation

11.24 IAS 1, *Presentation of Financial Statements*, requires an entity to present total revenue separately in profit or loss on the statement of profit or loss and other comprehensive income. An entity need not use the term revenue.

Disclosure

11.25 An entity should disclose its accounting policies for revenue recognition separately for the following categories: sales of goods, rendering of services, interest, dividends, and royalties. The disclosure should include the methods adopted for determining the stage of completion. Entities should also disclose the amount of revenue recognized from the exchange of goods or services in each of these categories.

Chapter 12

Accounting for Governmental Grants and Disclosure of Governmental Assistance

Overview

12.01 This chapter describes the accounting and disclosure of governmental grants and other forms of governmental assistance. Government assistance, whether cash or other resources, is sometimes referred to as a government subsidy, subvention, or premium.

Summary of Selected Accounting Guidance

12.02 International Accounting Standards (IAS) 20, *Accounting for Government Grants and Disclosure of Government Assistance*, is the primary accounting literature for guidance on how an entity should account for and disclose government grants and other forms of government assistance. Standing Interpretation Committee (SIC) Interpretation 10, *Government Assistance—No Specific Relation to Operating Activities*, addresses government assistance that only requires an entity to operate in certain regions or industry sectors.

Scope

12.03 IAS 20 defines *government assistance* as action by government, including government agencies and similar bodies, whether local, national, or international, that provides an economic benefit specific to the entity or a range of entities under certain criteria. *Government grants* are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the entity's operating activities.

12.04 This chapter and IAS 20 address government grants and other forms of government assistance, except for the following:

- Special problems related to the effects of changing prices on government grants in financial statements or in supplementary information of a similar nature
- Government assistance provided in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability (for example, income tax holidays and investment tax credits)
- Government grants addressed in IAS 41, *Agriculture*[1]
- Government participation in the ownership of an entity

12.05 The definitions of government grants and government assistance in IAS 20 do not include benefits an entity may receive from the following:

- Government assistance that the entity cannot reliably measure and cannot be distinguished from its normal trading transactions, such as technical or marketing advice and provision of guarantees
- Government actions that affect general trading conditions, such as improvements to the general transportation and communication infrastructure, and the supply of improved facilities, such as irrigation that provides an ongoing, indeterminate benefit to the entire local community

[1] International Accounting Standard 41, *Agriculture*, is beyond the scope of this book and is not included in any of the book's content.

Recognition

Government Grants

12.06 An entity recognizes a government grant, including nonmonetary grants, at fair value, when there is reasonable assurance that the entity will both

a. comply with the conditions attached to the grant, and

b. receive the grant.

An entity's receipt of a grant does not alone provide conclusive evidence that an entity has or will fulfill the conditions of the grant. For example, the government may require an entity to repay a grant already received if the entity failed to fulfill the necessary conditions.

12.07 The manner in which the entity receives a grant does not affect the entity's accounting. Whether the entity receives the grant in cash, by a nonmonetary asset, or as a reduction of a liability to the government, it accounts for receipt of the grant in the same way. For example, an entity treats a forgivable loan from the government as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

12.08 A government sometimes will extend a loan to an entity at an interest rate that is below the prevailing market rate. The entity treats such loans as governmental grants because it receives the benefit of the lower interest rate than it otherwise would from debt financing. IAS 20 requires the entity to recognize and measure the loan in accordance with guidance in IAS 39, *Financial Instruments: Recognition and Measurement*. Therefore, the entity will measure the benefit of a below-market interest rate as the difference between the proceeds received and the initial carrying amount of the loan and accounts for the benefit in accordance with IAS 20.

Author's Note: The International Accounting Standards Board issued International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, in November 2009 and again in October 2010 with an effective date of January 1, 2015. IFRS 9 amends IAS 20 by replacing references to IAS 39 with references to IFRS 9. Applying IFRS 9 early is permitted; however, if an entity adopts the guidance early, it should apply the related amendments.

12.09 If the entity recognizes a related contingent liability or contingent asset after recognizing a government grant, it will account for the contingency in accordance with the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

12.10 In accordance with the income approach to accounting for government grants, paragraph 12 of IAS 20 requires an entity to recognize income from a governmental grant in profit or loss on a systematic basis over the periods in which the entity recognizes expenses for the entity's related costs for which the grant is intended to compensate.

Alternative Approaches to Government Grant Accounting

12.11 IAS 20 describes two broad approaches to accounting for government grants: income approach and capital approach.

12.12 The *income approach* recognizes income from a government grant in profit or loss over one or more periods. Those who support the income approach consider government grants to be receipts from a source other than shareholders. Therefore, the entity should recognize income from the grants in profit and loss in the appropriate periods, as it would income from other nonshareholders. Supporters of this approach argue that an entity earns these grants through compliance with their provisions and governmental grants are rarely gratuitous. Additionally, because income and other taxes are expenses paid to the government recognized in profit or loss, it is considered logical that the entity should also recognize grants received from the government in profit or loss. Both are different aspects of the government's fiscal policies.

12.13 In contrast, the *capital approach* recognizes income from the grant directly in equity. Those in support of the capital approach believe that government grants are a financing device and should be dealt with as such in the statement of financial position, rather than recognized in profit or loss as an offset to the items of expense they finance. Because no repayment is expected, such grants should be recognized outside profit or loss, as described in paragraph 14 of IAS 20. In addition, supporters argue that it is inappropriate to recognize government grants in profit or loss because the grant is not earned, but instead represents an incentive provided by a government with no related costs.

12.14 Refer to paragraphs 12.13–.19 for a more extensive description of the arguments supporting these alternative approaches to accounting for government grants.

Immediate Financial Support

12.15 The two following circumstances describe government grants that become receivable after the entity has already met the conditions for receipt of the grant:

- Immediate financial support given as an incentive to undertake specific expenditures
- Compensation for expenses or losses incurred in a prior period

In these circumstances, the entity should recognize the grant in profit or loss in the period in which it becomes receivable.

12.16 A government may make grants for immediate financial support available only to a specific entity and not to an entire class of potential beneficiaries. For example, a government may give the grant directly to a specific subsidiary of an entity and not its parent. When this occurs, the entity should make sufficient disclosure to ensure that users of the financial statements clearly understand the grant's nature and its effects on the financial statements.

12.17 With respect to grants that compensate for prior expenses and losses, the entity should also provide sufficient disclosure so users of the financial statements clearly understand the nature and effects of the grants.

12.18 Finally, SIC 10 confirms that government assistance must meet the definition of a government grant in IAS 20 if it contains no conditions relating to operating activities other than the requirement to operate in certain geographic regions or industry sectors. Therefore, an entity accounts for such grants in accordance with IAS 20 and does not recognize the grant directly in equity.

Nonmonetary Government Grants

12.19 A grant may take the form of a transfer of nonmonetary assets, such as land or other resources. In this case, the entity recognizes both the grant and the associated asset at the fair value of the asset received. Alternatively, the entity may recognize both the asset and grant at a nominal amount.

Government Assistance

12.20 Some forms of government assistance cannot be measured reliably or cannot be distinguished from the entity's normal trading transactions. For example, a government may provide a range of government assistance to an entity including free marketing or technical advice, or guarantees. Although this assistance may provide benefits to the entity, it would be difficult, if not arbitrary, for the entity to separate the benefit from the government assistance from the benefit that accrues its normal operating activities.

Presentation

12.21 IAS 20 has different presentation requirements for grants related to assets and grants related to income.

Grants Related to Assets

12.22 Entities may receive grants to purchase, construct, or otherwise acquire long-term assets. These grants may include certain restrictions including the type of asset, the location of the asset, or the periods during which the entity should acquire and hold the asset. The entity presents grants related to assets, including nonmonetary grants at fair value, in the statement of financial position in one of the following ways:

- Gross presentation
  - Recognize the asset and the related liability (deferred income) for the grant separately in the statement of financial position.
  - Depreciate or amortize the carrying amount of the asset over its estimated useful life.
  - Amortize the deferred income to profit or loss over the estimated useful life of the asset.
- Net presentation
  - Recognize the asset in the statement of financial position measured in accordance with the relevant IFRSs.
  - Reduce the carrying amount of the asset by the amount of the related grant.
  - Depreciate the carrying value of the net asset over its estimated useful life (with the effect that the amount of depreciation expense recognized is reduced.)

12.23 Acquisitions of assets and related awards of government grants generally involve significant financing and investing cash flows. Therefore, IAS 20 cautions that the entity's choice of gross or net presentation on the balance sheet should not affect disclosure of the gross cash flows related to these events in the statement of cash flows. Refer to the guidance in chapter 15, "Statement of Cash Flows," of this book and IAS 7, *Statement of Cash Flows*.

Grants Related to Income

12.24 An entity presents grants related to income, which are government grants that an entity receives other than those related to assets, in profit or loss in one of the following two ways:

- As a separate credit line item or within a general line item, such as "Other Income"
- As a reduction of the related expense (for example, depreciation expense)

12.25 IAS 20 permits both presentation methods. However, the entity may need to disclose additional information so that users of the financial statements understand the effects of the grants. Paragraph 31 of IAS 20 cautions that it is usually appropriate for the entity to disclose the effect of government grants on any item of income or expense that IFRSs require the entity to disclose separately.

Repayment of Government Grants

12.26 If a governmental grant becomes repayable, the entity should account for the event as a change in accounting estimate in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimate and Errors*.

12.27 The entity first applies a repayment of a grant related to income against any unamortized deferred income account. If the repayment exceeds the carrying value of any unamortized deferred income, or when no unamortized deferred income remains, the entity recognizes the repayment immediately in profit or loss.

12.28 The entity recognizes a repayment of a grant related to an asset by increasing the carrying amount of the asset or reducing the carrying value of any unamortized deferred income by the amount repayable, in accordance with paragraph 32 of IAS 20. The entity immediately recognizes in profit or loss the cumulative additional depreciation that it would have recognized in profit or loss to date in the absence of the grant.

12.29 The entity should consider whether the circumstances that gave rise to the grant's repayment are an indicator that it should test the carrying value of the related asset for impairment in accordance with paragraph 33 of IAS 20. Refer to chapter 6, "Impairment of Assets," of this book and IAS 36, *Impairment of Assets*, for additional guidance regarding impairment testing and measurement.

Disclosure

12.30 Paragraph 39 of IAS 20 requires an entity to disclose all of the following:

- The accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements
- The nature and extent of government grants recognized in the financial statements and an indication of other forms of government assistance from which the entity directly benefits
- Unfulfilled conditions and other contingencies attaching to government assistance that it recognized

Chapter 13

Share-Based Payment Transactions

Overview

13.01 An entity may grant shares or share options to directors, executive management, and other employees as a form of compensation, and will sometimes issue shares or share options to suppliers as payment for goods and services.

13.02 This chapter describes the financial reporting by an entity that engages in share-based payment transactions. In particular, International Financial Reporting Standards (IFRSs) require an entity to reflect the effects of these transactions, including the expenses associated with share options granted to employees, in an entity's statements of profit or loss and other comprehensive income and financial position. Additionally, this chapter describes the required disclosures needed to allow users of the financial statements to understand the nature and extent of share-based payment transactions, the effects of these transactions on profit or loss, and the fair value of the goods or services received in exchange for such transactions.

Summary of Selective Accounting Guidance

13.03 The primary authoritative literature that relates to the accounting for share-based payments is IFRS 2, *Share-based Payment*.

Author's Note: The International Accounting Standards Board amended IFRS 2, *Share-based Payment*, by issuing the following new standards:

- IFRS 9, *Financial Instruments* (issued in November 2009 and again in October 2010; is effective for annual periods beginning on or after January 1, 2015).

  This amendment replaces references in IFRS 2 to International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, with references to IFRS 9.
- IFRS 10, *Consolidated Financial Statements* (issued May 2011; effective for annual periods beginning on or after January 1, 2013).

  This amendment replaces references in IFRS 2 to IAS 27, *Consolidated and Separate Financial Statements*, with references to IFRS 10.
- IFRS 11, *Joint Arrangements* (issued May 2011; effective for annual periods beginning on or after January 1, 2013).

  This amendment replaced references to IFRS 2 to IAS 31, *Interests in Joint Ventures*, with references to IFRS 11.
- IFRS 13, *Fair Value Measurement* (issued May 2011; effective for annual periods beginning on or after January 1, 2013).

  This amendment explains that IFRS 2 uses the term *fair value* in a way that differs from the definition of fair value in IFRS 13. An entity should use the definition of fair value in IFRS 2 when applying this standard.

Scope and Scope Exceptions

13.04 The scope of this chapter and IFRS 2 applies to all share-based payment transactions, including those exchanged for goods or services, whether or not the entity can specifically identify some or all of the goods or services received. Goods received in exchange of share-based payments may include inventories; property, plant, and equipment; intangible assets; consumables; and other nonfinancial assets.

13.05 The scope of IFRS 2 includes the following transactions:

- Equity-settled share-based payment transactions, in which the entity receives goods or services as consideration for equity instruments of the entity, including shares or share options

- Cash-settled share-based payment transactions, in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price or value of the entity's shares or other equity instruments of the entity
- Transactions in which an entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of the goods or services with a choice to either settle the transaction with a payment of cash or other assets, or by receiving equity instruments

In the absence of specifically identifiable goods or services, other circumstances may exist to indicate that goods or services have been, or will be, received in these types of transactions. Therefore, these types of transactions are within the scope of IFRS 2, except as noted in paragraph 13.08.

13.06 An entity accounts for equity instruments issued in a business combination and other equity restructurings in accordance with IFRS 3, *Business Combinations*. The following transactions are within the scope of IFRS 2:

- Grants of equity instruments to employees of the acquired entity in their capacity as employees, such as in return for continued service after the completion of the business combination
- Cancellation, replacement, or other modification of share-based payment arrangements because of a business combination or other equity restructuring

13.07 When a group entity acquires or receives goods or services, another group entity or a shareholder of a group entity may settle or have the obligation to settle the share-based transaction on its behalf. These transactions are within the scope of IFRS 2 when the purpose of the share-based payment transaction clearly indicates that it is for the payment of goods or services supplied to the entity receiving them.

13.08 IFRS 2 and this chapter also do not apply to the following:

- Transactions with other parties or employees acting in the capacity of a holder of the entity's equity. For example, an entity may give employees who are holders of the entity's equity instruments a right to acquire additional equity instruments below fair value because they are already equity holders, not because they are employees receiving compensation for continued service. Granting or exercising of rights given to equity holders in their capacity as equity holders is not subject to the requirements of IFRS 2.
- Issues of equity instruments in a business combination in exchange for control of the acquired entity are not within the scope of IFRS 2. Therefore, share-based payment transactions that involve the entity acquiring goods as part of any of the following are not within the scope of IFRS 2:
  - Acquisition of goods as part of the net assets acquired in a business combination, or in a combination of entities under a common control. An entity would apply the guidance in IFRS 3 to these transactions. Refer to chapter 16, "Business Combinations," of this book for guidance on the accounting for business combinations.
  - Contribution of a business on the formation of a joint venture as defined in IFRS 11. Refer to chapter 8, "Investments in Associates and Joint Arrangements," of this book for guidance on the accounting for a joint venture.
- Share-based transactions when an entity receives or acquires goods or services under a contract that is within the scope of one of the following:
  - Paragraphs 8–10 of IAS 32, *Financial Instruments: Presentation*.
  - Paragraphs 5–7 of IAS 39.

Recognition

13.09 An entity should recognize goods or services received or acquired in a share-based payment transaction when the entity obtains the goods or receives the services. An entity recognizes these goods or services as an asset when the asset recognition criteria are met; otherwise, the entity recognizes an expense. Normally, an entity consumes goods over a period of time, as is the case for inventory, and it should only recognize the cost as an expense when it sells or consumes the goods. In contrast, services are typically consumed immediately and the entity should recognize the expense immediately as well. Sometimes goods or services might not qualify for recognition as assets under the relevant IFRS. In this case, the entity should recognize an expense immediately, regardless of whether the goods or services are consumed, such as when the entity incurs costs for goods or services in the research phase of a project.

13.10 An entity that receives goods or services in an equity-settled share-based payment transaction should record an increase in equity. If goods or services are acquired in a cash-settled share-based payment transaction, the entity should recognize a liability.

Equity-Settled Share-Based Payment Transactions

13.11 Equity-settled share-based payment transactions occur when an entity receives goods or services as consideration for its own equity instruments, which may include shares or share options.

13.12 An entity recognizes and measures goods or services received in an equity-settled share-based payment transaction at their fair value, unless it cannot estimate fair value reliably, with a corresponding increase in equity. If the entity cannot measure the fair value of the goods or services received reliably, then it should measure their value and the corresponding increase in equity based upon the fair value of the entity's equity instruments granted. The entity determines the fair value of the entity's equity instruments granted by multiplying the fair value of the equity instruments granted, at their specified date, by the number of equity instruments that vest.

13.13 In addition to providing cash compensation and other employee benefits, an entity commonly issues shares, share options, or other equity instruments to some employees as part of a compensation package. When an entity engages in equity-settled share-based payment transactions with employees and others that provide similar services, it should measure the fair value of these services by reference to the fair value of the equity instruments, at the grant date.[1]

13.14 It is generally not possible to directly relate individual components of an employee's compensation package with the services an entity receives in exchange for each component. It may also not be possible to measure the fair value of the employee's total compensation package independent of the equity instruments granted. Additionally, the entity sometimes grants shares or share options as part of a bonus arrangement, rather than as part of basic compensation. For example, an entity may provide an incentive to employees to retain their loyalty or to reward them for their efforts in improving the entity's performance. When the entity grants shares or share options that are in addition to the other compensation provided to an employee, the entity is making an additional payment to obtain additional benefits. However, it is likely too difficult for the entity to estimate the fair value of the additional benefits it expects to receive. Because directly measuring the fair value of services received from an employee is very difficult, an entity should measure the fair value of these services using the fair value of the equity instrument granted.

13.15 Although estimating the fair value of services received from employees reliably may be difficult, if not impossible, IFRS 2 presumes that the entity can reliably measure the fair value of goods or services received in an equity-settled share-based payment transaction with parties other than employees. The date the entity obtains the goods or the counterparty renders service is the date that the entity should measure fair value. In rare cases, when the entity cannot reliably measure the fair value of the goods or services received, an entity should measure these goods or services, together with the corresponding increase in equity, by reference to the fair value of the equity instruments granted. The entity measures the fair value of the equity instruments granted at the date the counterparty rendered the services or the entity obtained the goods.

13.16 The situation in which the identifiable consideration an entity receives, if any, appears to be less than the fair value of the equity instruments granted, or a liability incurred, typically indicates that the entity has or will receive other unidentifiable consideration. In this case, the entity measures the identifiable goods or services received in accordance with IFRS 2 and the unidentifiable goods or services as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services at the grant date.

[1] For additional guidance regarding the definition of a grant date, refer to IG1–IG4 of the *Guidance on Implementing IFRS 2 Share-Based Payments*.

For similar situations involving cash-settled transactions, the entity measures the liability at the end of each reporting period until it is settled, as described later in paragraphs 13.42–.44.

13.17 Refer to paragraphs IG 9–IG 22 of the *Guidance on Implementing IFRS 2-Share-based Payment* (guidance) for illustrative examples of equity-settled share-based payment transactions. Refer to paragraph IG 24 of the guidance for a summary of the accounting treatments under various conditions that determine whether the counterparty has received an equity instrument.

Transactions In Which the Entity Receives Services

13.18 When a grant of an equity instrument vests immediately, the counterparty's entitlement is no longer conditional and it is not required to provide additional services. In the absence of evidence to the contrary, an entity should presume that the counterparty provided the services in consideration for the equity instruments granted. Therefore, the entity recognizes the services received in full on the grant date, with a corresponding increase in equity.

13.19 On occasion, equity instruments granted to the counterparty may not vest until the counterparty provides services over a specified period. The entity should consider the equity instruments granted as consideration for the services to be rendered by the counterparty over the future vesting period. An entity should account for the services by the counterparty as they are rendered with a corresponding increase in equity. Examples of such transactions include the following:

- An entity grants share options to an employee that are conditional on the employee completing three years of service. In this situation, the entity should presume that the share options are consideration for the employee's service over the three-year vesting period.
- An entity grants share options to an employee conditional on he or she remaining in the entity's employment until a performance condition is achieved. The length of the vesting period will vary because it is dependent upon satisfactory achievement of a performance condition. An entity should presume that it will receive the employee's future services as consideration for the share options over the expected vesting period, which is estimated at the grant date based on the most likely outcome of the performance condition. If the entity determines that the performance condition is
  - a market condition, then the entity should the estimate of the length of the expected vesting period consistent with the assumptions used in estimating the fair value of the options granted, and it should not be subsequently revise this estimate.
  - not a market condition, then the entity should revise the estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period will differ from previous estimates.

Transactions Measured By Using the Fair Value of the Equity Instruments Granted

Determining the Fair Value of Equity Instruments Granted

13.20 An entity should measure the fair value of equity instruments granted at the measurement date. The entity should base fair value on market prices, if available, taking into account the terms and conditions on which it granted the equity instruments, subject to the requirements of vesting and nonvesting conditions and reload features.

13.21 When market prices are not available, an entity should use a valuation technique to estimate the price of the equity instruments to determine their fair value. An entity estimates the price of the equity instruments, at the measurement date, assuming an arm's length transaction exists between willing and knowledgeable parties. The entity should use a valuation technique consistent with generally accepted valuation methodologies for pricing financial instruments. The entity should incorporate all factors and assumptions that knowledgeable and willing market participants would consider when setting the price, subject to the requirements of vesting and nonvesting conditions and reload features.

13.22 Refer to the application guidance in paragraphs B1–B41 of appendix B in IFRS 2 for additional guidance on the measurement of the fair value of share and share options, including specific terms and conditions that are common features of a grant of share or share options to employees.

Treatment of Vesting Conditions

13.23 *Vesting conditions* are conditions that determine whether an entity received the services that entitle the counterparty to receive cash, other assets, or equity instruments of the entity under a shared-based payment arrangement. Vesting conditions are either service or performance conditions.

13.24 The following are examples of grants of equity instruments that are conditional on meeting specific vesting conditions:

- A grant of shares or share options to an employee that includes a service condition; for example, the vesting condition requires an employee to remain in the entity's employment for a specified period of time.
- A grant of shares or share options that includes performance condition; for example, the vesting condition requires the entity to achieve a specified growth in profit or a specified increase in the entity's share price.

13.25 An entity does not take vesting conditions, other than market conditions, into account when it estimates the fair value of the shares or share options at the measurement date. Instead, the entity should take the vesting conditions into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the entity bases the amount recognized for goods or services received as consideration for the equity instruments granted on the number of equity instruments that eventually vest. Therefore, on a cumulative basis, the entity recognizes no amount for goods or services received if the equity instruments granted do not vest because the vesting conditions were not satisfied.

13.26 Goods and services received are recognized by an entity during the vesting period based on the best estimate of the number of equity instruments expected to vest. An entity should revise the estimated number of equity instruments expected to vest if there is subsequent information that indicates the expected number differs from previous estimates. Subject to market conditions described in paragraph 13.27, on the vesting date, the entity revises the estimate to equal the number of equity instruments ultimately vested.

13.27 When an entity estimates the fair value of equity instruments granted, it takes into account market conditions, such as the target price on which the equity instrument vests or is exercisable. Therefore, the entity recognizes the goods or services received from a counterparty who has satisfied all other vesting conditions, such as a service condition to remain the entity's employee for a specific period of time, irrespective of whether that market condition is satisfied.

13.28 Refer to IG 4A of the guidance for additional information regarding the definition of vesting conditions. Refer to paragraphs IG 5–IG 8 of the guidance for information in determining the measurement date for transactions with parties other than employees and transactional arrangements.

Treatment of Nonvesting Conditions

13.29 An entity takes into account all nonvesting conditions when it estimates the fair value of the equity instruments granted. Therefore, an entity recognizes the goods or services received from a counterparty when all vesting conditions that are not market conditions have been met, irrespective of whether those nonvesting conditions are satisfied.

Treatment of a Reload Feature

13.30 Options may include a feature known as a reload feature, which provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.

13.31 An entity does not take into account a reload feature when it estimates the fair value of options granted at the measurement date. Instead, if and when an entity grants a reload option, it will account for the new option granted at the time the counterparty uses shares to satisfy the exercise price of the previous share option.

After Vesting Date

13.32 After the vesting date, an entity should not make any subsequent adjustments to total equity because it already recognized the goods or services received and the corresponding increase in equity. For example, the entity should not subsequently reverse an amount recognized for services received from an employee who later forfeits their vested equity instruments. Similarly, the entity should not reverse options recognized that the counterparty does not exercise. However, IFRS 2 does not preclude an entity from recognizing a transfer of amounts within equity, such as transferring from one component of equity to another.

Inability to Estimate the Fair Value of the Equity Instruments Reliably

13.33 In rare cases, an entity cannot estimate the fair value of equity instruments granted reliably at the measurement date. In these cases, an entity may

- measure the equity instruments at their intrinsic value.

  The *intrinsic value* on an equity instrument is the difference between the fair value of the share the counterparty has the right to subscribe to or receive, and the price, if any, the counterparty is or will be required to pay for those shares. The intrinsic value of the equity instruments is measured initially at the date the goods are obtained by the entity or on the date the counterparty renders the services. The entity remeasures intrinsic value subsequently at the end of each reporting period and at the date of the final settlement. The entity recognizes any changes in intrinsic value in profit or loss. The entity settles the share-based payment arrangement for a grant of share options when the options are exercised, forfeited (such as upon cessation of employment), or lapse.

- recognize the goods or services received based upon the number of equity instruments that ultimately vest or are exercised.

  For example, when applying this requirement to share options, an entity recognizes the goods or services received during the vesting period, except when the guidance does not apply due to a market condition. When this occurs, the entity bases the amount recognized for goods or services received during the vesting period on the expected number of shares that will vest. If necessary, the entity revises its estimate if subsequent information indicates that the number of expected share options to vest differs from previous estimates. On the vesting date, an entity will revise the estimate to equal the number of equity instruments that ultimately vested. Subsequent to the vesting date, an entity should reverse the amount recognized for goods or services received, if the share options lapse at the end of their share life or are later forfeited.

13.34 Any modifications to the terms and conditions on which an equity instrument was granted are taken into account when calculating the intrinsic value. Therefore, it is not necessary for an entity to apply the guidance described in paragraphs 13.35–.40. If an entity has applied the guidance in paragraph 13.33 to the settlement of a grant of equity instruments

- the entity should account for a settlement that occurs during the vesting period as an acceleration of vesting and immediately recognize the amount that would otherwise have been recognized for the services received over the remainder of the vesting period.
- the entity should account for any payment made on settlement as the repurchase of equity instruments (as a deduction from equity), except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. If the latter occurs, the entity recognizes such excess as an expense.

Cancellations, Settlements, and Other Modifications of a Grant's Terms and Conditions

13.35 An entity might make modifications to the terms and conditions on which it granted equity instruments. Modifications might include grant cancellation or settlement.

13.36 An entity should apply the requirements in paragraphs 13.37–.40 when accounting for the effects of modifications to the following share-based payment transactions:

- Transactions with employees; for example, a reduction to the exercise price of options granted to employees.
- Transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted, with the grant date being the date the entity obtained the goods or the date the counterparty rendered the services.

13.37 At a minimum, an entity should recognize the services rendered by measuring, at the grant date, the fair value of the equity instruments granted. An entity should apply this guidance, whether or not the entity modified the terms and conditions, cancelled, or settled the grant, unless there is a failure to satisfy a vesting condition, other than a market condition, that was specified at the grant date. An entity should recognize the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

13.38 When a grant of equity instruments settles during the vesting period or is cancelled, other than by forfeiture, for not satisfying vesting conditions, an entity should

- account for the cancellation or settlement as an acceleration of vesting, and recognize immediately the amount that otherwise would have been recognized for services received over the remainder of the vesting period.
- account for any payment made to the employee on the cancellation or settlement of the grant as a repurchase of an equity interest. For example, the entity accounts for this transaction a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Under the latter circumstances, the entity recognizes an expense for the excess. If the share-based payment arrangement includes a liability component, an entity should remeasure the fair value of the liability at the date of cancellation or settlement. The entity accounts for any payments made to settle the liability component for as an extinguishment of the liability.
- account for grants of replacement equity instruments in the same way an entity accounts for a modification of an original grant of equity instruments. A replacement occurs when new equity instruments are granted to employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments at the date the replacement. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation. An entity accounts for this transactions as a repurchase of an equity interest and recognizes a deduction from equity. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, then the entity should account for those new equity instruments as a new grant of equity instruments.

13.39 When either the counterparty or the entity can choose whether or not to meet a nonvesting condition, the entity should treat the failure to meet the nonvesting condition during the vesting period by the entity or the counterparty as a cancellation.

13.40 When the entity repurchases vested equity instruments, it accounts for the payment to employees as a deduction from equity, except to the extent that the payment exceeded the fair value of the repurchased equity instruments measured at the repurchase date. In the latter case, the entity recognizes an expense for any such excess.

13.41 Refer to the application guidance in paragraphs B42–B44 of appendix B in IFRS 2 for additional guidance regarding the modifications to equity-settled share-based payment arrangements.

Cash-Settled Share-Based Payment Transactions

13.42 An entity should measure goods or services acquired in a cash-settled share-based payment transaction, as well as the liability incurred, at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at the end of each reporting period and at the date of settlement. The entity recognizes any changes in fair value in profit or loss for the period. For example, an entity may

- grant share appreciation rights to employees as part of their compensation package, whereby the employees will become entitled to a future cash payment, rather than an equity instrument, but the cash payment is based on the increase in the entity's share price from a specified level over a specified period of time.
- grant to its employees a right to receive a future cash payment by granting to them a right to shares, including shares to be issued upon the exercise of share options, that are redeemable, either mandatorily (when employment ends) or at the employee's option.

13.43 An entity recognizes services received and the liability to pay for those services as the employee renders the services. For example, some share appreciation rights vest immediately. Therefore, the employees are not required to provide additional service to be entitled to receive the cash payment. In this case, the entity should presume that, in the absence of evidence to the contrary, it has already received the employee's services in exchange for the share appreciation rights. Therefore, it will immediately recognize the services received and the corresponding liability. Conversely, if the share appreciation rights do not vest until the employees have completed a specified period of service, the entity recognizes the services received and the corresponding liability over the period the employee renders services.

13.44 An entity should initially measure the liability at the end of each reporting period until settlement at the fair value of the share appreciation rights using an option pricing model. The option pricing model takes into account the terms and conditions on which the share appreciation rights were granted, and the extent to which the entity's employees have rendered services to date.

Cash Alternatives

13.45 When a share-based payment transaction has terms that provide an entity, or the counterparty, with the choice to settle the transaction in cash or other assets or by issuing equity instruments, an entity accounts for that transaction, or components of that transaction, as a cash-settled share-based payment transaction to the extent that the entity has incurred a liability to settle the transaction in cash or other assets. If no liability has been incurred, an entity should account for that transaction as an equity-settled share-based payment transaction.

Counterparty Decides Settlement in Cash or Equity

13.46 When an entity grants the counterparty the right to decide whether to settle the share-based payment transaction in cash or other assets, or by issuing equity instruments, it has granted a compound financial instrument. The compound financial instrument includes the following:

- A debt component that represents the counterparty's right to demand payment in cash or other assets
- An equity component that represents the counterparty's right to demand settlement in equity instruments instead of cash or other assets

13.47 For transactions with parties other than employees, in which an entity measures the fair value of the goods or services received directly, the entity should measure the equity component as the difference between the fair value of the goods or services received and the fair value of the debt component at the date when the goods or services are received.

13.48 An entity should account for other transactions, including those with employees, by measuring the fair value of the compound financial instrument at the measurement date. The fair value measurement takes into account the terms and conditions on which the rights to settle in cash or other assets or equity instruments were granted.

13.49 An entity first measures the fair value of the debt component, and then measures the equity component's fair value. This measurement takes into account the fact that the counterparty must forfeit their right to receive cash in order to receive an equity instrument. The sum of the fair values of the debt and equity component is the fair value of the compound financial instrument.

13.50 An entity often structures share-based payment transactions in which the counterparty has the choice of settlement so that the fair value of one settlement alternative is the same as the other. An example might include providing the counterparty with a choice of receiving share options or cash-settled share appreciation rights. In this transaction, the fair value of the equity component is zero, so the fair value of the compound financial instrument is the same as the debt component's fair value. When the fair value of the settlement alternatives differ, the equity component's fair value will usually be greater than zero and, therefore, the fair value of the compound financial instrument will be greater than the debt component's fair value.

13.51 The entity should account for the goods or services received or acquired in exchange for each component of the compound financial instrument separately. An entity should recognize each component of the compound financial instrument as follows:

- For the debt component, the entity recognizes the goods and services acquired and its liability to pay for those goods or services, as the counterparty supplies the goods or services, in accordance with the requirements that apply to cash-settled share-based payment transactions.
- For the equity component, if any, the entity recognizes the goods or services received and an increase in equity as the counterparty supplies goods or services, in accordance with the requirements applying to equity-settled share-based payment transactions.

13.52 At the settlement date, the entity remeasures the liability to its fair value. If the entity issues equity instruments instead of paying cash, the entity transfers the liability directly to equity as consideration for the equity instruments issued.

13.53 At settlement, if an entity pays cash instead of issuing equity instruments, the entity uses the payment to settle the liability in full. Any previously recognized equity components remain in equity. When the counterparty elected to receive cash, they forfeited their right to receive equity instruments. However, IFRS 2 does not preclude an entity from recognizing a transfer within equity, such as the transferring from one component of equity to another.

Whether to Settle a Share-Based Payment Transaction in Cash or Equity

13.54 When the terms of the arrangement provide an entity with the choice of whether to settle a share-based payment transaction in cash or by issuing equity instruments, the entity should determine whether it has a present obligation to settle the transaction in cash. To the extent it has an obligation to settle in cash, the entity accounts for the transaction as a cash-settled share-based payment transaction. If the choice of settling in equity instruments has no commercial substance (for example, because the issuance of shares is legally prohibited), then the entity has a present obligation to settle the transaction in cash. Similarly, an entity may have a stated policy or past practice of settling in cash, or generally settles in cash at the request of the counterparty, both of which imply that the entity has a constructive obligation to settle in cash.

13.55 The requirements that apply to equity-settled share based payment transactions should apply when an obligation to settle a transaction in cash does not exist. When the entity initially accounts for the transaction as an equity-settled share-based payment transaction, the entity will account for the settlement as follows:

a. When the entity elects to settle the transaction in cash, it accounts for the cash payment as a repurchase of an equity interest, a deduction from equity, except as noted in (*c*), which follows.

b. When the entity elects to settle the transaction by issuing equity instruments, no further accounting is required unless, if necessary, the entity transfers the equity instrument from one component of equity to another, except when as noted in (*c*), which follows.

c. When an entity elects the settlement alternative with the higher fair value at the date of settlement, the entity recognizes an additional expense for the excess value given to the counterparty. For example, the entity measures the extra compensation as the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Share-Based Payment Transactions Among Group Entities

13.56 Group entities sometimes engage in share-based payment transactions. In the separate or individual financial statements of the entity receiving the goods or services (the receiving entity), the receiving entity should measure those goods or services received as cash-settled or equity-settled payment transactions by assessing the nature of the awards granted and its own rights and obligations. The amount recognized at the level of the individual receiving entity may differ from the amount recognized by the consolidated group or by the group entity that settles the share-based payment transaction (if different from the receiving entity).

13.57 The goods or services received by the entity are measured as an equity-settled share-based payment transaction when the awards granted are in the receiving entity's own equity instruments, or if the receiving entity has no obligation to settle the share-based payment transaction. The receiving entity subsequently remeasures the equity-settled share-based payment transaction only for changes in nonmarket vesting conditions as described in paragraphs 13.23–.26. In all other circumstances, the goods or services received are measured as a cash-settled share-based payment transaction.

13.58 When another entity in the group receives the goods or services, the entity settling the share-based payment transaction (settling entity) should only recognize the transaction as an equity-settled share-based payment transaction if the transaction settles in the settling entity's own equity instruments. If not, the settling entity should recognize the transaction as a cash-settled share-based payment transaction.

13.59 When group transactions involve repayment arrangements that require one group entity to pay another group entity for providing share-based payments to suppliers of goods or services, the receiving entity should account for the transaction as a share-based payment transaction irrespective of the intragroup repayment arrangements.

13.60 Refer to the application guidance in paragraphs B45–B61 of appendix B in IFRS 2 for additional guidance regarding share-based payment transactions among group entities.

Disclosure

13.61 IFRS 2 requires an entity to include the following minimum disclosures in its financial statements in order to provide users of those statements with the ability to understand the nature and the extent of the entity's share-based payment arrangements that existed during the period:

- A description of each type of share-based payment arrangement that exists at any time during the period, including the general terms and conditions of each arrangement. Such terms and conditions include vesting requirements, the maximum term of options granted, and the method of settlement, such as whether the share-based payment arrangement settles in cash or in equity. An entity with substantially similar types of share-based payment arrangements may aggregate this information unless separate disclosure of each arrangement is necessary to better enable users of the financial statements the ability to understand the nature and extent of the share-based payment arrangements.
- The number and weighted average exercise prices of share options for each of the following groups of options:
  - Outstanding at the beginning of the period
  - Granted during the period
  - Forfeited during the period
  - Exercised during the period
  - Expired during the period
  - Outstanding at the end of the period
  - Exercisable at the end of the period

- For share options exercised during the period, an entity should disclose the weighted average share price at the date of exercise. If the options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.
- For share options outstanding at the end of the period, an entity should disclose the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

13.62 An entity should disclose information that provides users with the ability to determine how an entity determined the fair value of the goods and services received, or the fair value of the equity instruments granted during the period. If an entity measured the fair value of goods or services received as consideration for its equity instruments indirectly, by reference to the fair value of the equity instruments granted, paragraph 47 of IFRS 2 states that the entity should disclose following information:

- For share options granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including the following:
  - The option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise
  - How expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility
  - Whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition
- For other equity instruments granted during the period, other than share options, the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured, including the following:
  - If an observable market price was not used for the measurement of fair value, then information describing how the fair value was determined, whether and how
    - expected dividends were incorporated into the measurement of fair value
    - any other features of the equity instruments granted were incorporated into the measurement of fair value
- For share-based payments modified during the period, disclosure of the following:
  - An explanation of those modifications
  - As a result of the modifications made during the period, the incremental fair value granted
  - Information regarding how the incremental fair value granted was measured, and when applicable, the consistency with other disclosures in this paragraph

13.63 An entity should disclose how it directly measured and determined the fair value of goods or services received during the period; for example, whether fair value was measured at a market price for those goods or services. If the entity has rebutted the presumption that the fair value of goods or services can easily be determined, then the entity should disclose that fact and provide an explanation of why it was rebutted.

13.64 The disclosure information in an entity's financial statement should enable users to understand the effect of the share-based payment transactions on the entity's profit or loss for the period and on its statement of financial position. Paragraph 51 of IFRS 2 states that an entity should disclose at least the following:

- The total expense recognized for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and therefore recognized immediately as an expense. This would include a separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions.

- For liabilities arising from share-based payment transactions, an entity should disclose
  - the total carrying amount at the end of the period; and
  - the total intrinsic value at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period, for example vested share appreciation rights.

13.65 When the required disclosure information in IFRS 2 does not satisfy a user's need to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position, then an entity should disclose additional information as necessary to satisfy the needs of the user.

Chapter 14

Earnings Per Share

Overview

14.01 The importance of earnings per share (EPS) for equity investment valuation cannot be underestimated. EPS is also one of the two components of the price-to-earnings valuation ratio. Despite some limitations in its usefulness, research has shown that analyst forecasts of EPS, revisions in these forecasts, as well as an entity's ability to meet or beat these forecasts, can impact share price. Therefore, management considers reported EPS to be a critical part of its communications with shareowners and investors.

14.02 EPS is one of the performance measures that investors and other users of an entity's financial statements use to compare the entity's performance from one reporting period to another. EPS is also used to compare one entity's EPS to that of other entities: competitors within its industry, entities in different industries, and entities in different countries.

14.03 An entity presents EPS in its financial statements when its ordinary or potential ordinary shares trade in a public market, or if the entity is in the process of filing with a securities regulator to have its shares traded in a public market.

14.04 This chapter describes the requirements for calculating and presenting EPS and also provides some illustrative examples.

Summary of Selected Accounting Guidance

14.05 The primary accounting literature establishing the requirements for calculating and presenting EPS is International Accounting Standard (IAS) 33, *Earnings Per Share*. An entity is also required to apply the guidance in IAS 1, *Presentation of Financial Statements*; International Financial Reporting Standard (IFRS) 10, *Consolidated Statements*; and IAS 27, *Separate Financial Statements*, when determining how to present and prepare consolidated or separate (parent only) financial statements. For a detailed discussion of IAS 1, IFRS 10, and IAS 27, refer to chapter 2, "The Conceptual Framework and Financial Statement Presentation," and chapter 29, "Consolidated and Separate Financial Statements,"of this book.

Scope and Scope Exceptions

14.06 This chapter and IAS 33 apply to the following types of financial statements:

- An entity's individual or separate financial statements
- A group's consolidated financial statements

14.07 A group consists of a parent entity and one or more subsidiaries. Separate or individual financial statements refer to the financial statements of a parent in a group in which the entity accounts for its subsidiaries using the equity method, rather than consolidation.

14.08 An entity should calculate and present EPS when it meets one of the following criteria:

- The entity's ordinary or potentially ordinary shares are traded in a public market.
- The entity files, or is in the process of filing, its financial statements with a securities commission or other regulator for the purpose of issuing ordinary shares in a public market.

14.09 An entity should always calculate and present EPS in accordance with IAS 33. When an entity prepares both consolidated and separate financial statements, IAS 33 requires presentation of EPS based only on consolidated information. However, when an entity chooses to calculate and present EPS based on information in its separate financial statement, IAS 33 only permits the entity to present EPS in the statement of profit or loss and other comprehensive income in those separate financial statements. IAS 33 does not permit an entity to present EPS in the consolidated financial statements that it calculated based on information in its separate financial statements.

14.10 IAS 1 permits an entity to present the information required in a statement of profit or loss and other comprehensive income in either of the following:

- One statement of profit or loss and other comprehensive income that includes three totals: profit or loss, total other comprehensive income, and total comprehensive income
- One of the following two separate statements:
  - Statement of profit or loss that ends with total profit or loss
  - Statement of profit or loss and other comprehensive income that begins with total profit or loss and ends with total comprehensive income

14.11 When an entity chooses to present a separate statement of profit or loss, IAS 33 requires the entity to present EPS only in that separate statement.

Measurement

14.12 Calculating the EPS ratio requires an entity to determine appropriate measurements for earnings (profit or loss) and the number of equity shares to be used as the numerator and denominator, respectively.

14.13 With respect to earnings, IAS 33 requires an entity to calculate both basic and diluted EPS using the following amounts:

- Reported amount of total profit or loss attributable to holders of ordinary equity shares of the parent entity
- Profit or loss from continuing operations attributable to those equity holders when there is a distinction between continuing and discontinued operations, if presented

14.14 Paragraph 81B of IAS 1 requires an entity to allocate total profit or loss and comprehensive income attributable to holders of ordinary equity shares of the parent entity and any noncontrolling interest. An entity also adjusts both total profit or loss and profit or loss from continuing operations, if applicable, for the after-tax amounts of preferred (preference) share dividends and other similar effects of its preferred shares classified as equity instruments.

14.15 Paragraph 5 of IAS 33 defines the following key terms that are important when applying the standard's requirements:

- An *ordinary share* is an equity instrument that is subordinate to all other classes of equity instruments.
- A *potential ordinary share* is a financial instrument or other contract that may entitle its holder to ordinary shares. Some examples of potential ordinary shares are
  - convertible preferred shares or convertible debt instruments.
  - warrants, options, or rights.
  - employee share option purchase plans.
  - contractual rights to purchase shares.
  - some types of contingent issuance contracts or agreements (for example, contingent shares arising in a business combination).
- *Dilution* is a reduction in EPS or an increase in loss per share that results from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.
- *Antidilution* is an increase in EPS or a reduction in loss per share that results from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.
- A *contingent share agreement* is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

- *Contingently issuable ordinary shares* are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.
- *Options, warrants, and their equivalents* are financial instruments that give the holder the right to purchase ordinary shares. (Refer to paragraphs A6–A9 of appendix A, "Application Guide," of IAS 33 for additional guidance regarding options, warrants, and their equivalents.)
- *Put options* on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period. (Refer to paragraph 14.47 for an example of a written put option.)

14.16 Ordinary shares participate in profit for the period only after other types of shares, such as preferred (preference) shares, have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends. Shares of different classes may have different rights. Refer to paragraphs A13–A16 of appendix A of IAS 33 for additional guidance regarding participating equity instruments, two-class ordinary shares, and partially paid shares. In addition, example 11 of the illustrative examples that accompany IAS 33 provides an example of participating equity instruments and two-class ordinary shares.

Basic Earnings Per Share

14.17 An entity calculates basic EPS as follows:

$$\text{EPS} = \frac{\text{Numerator}}{\text{Denominator}} = \frac{\text{N}}{\text{D}}$$

Where:

N = Profit or loss attributable to holders of the ordinary equity shares adjusted for the after-tax effects of the following:

- Preferred share dividends
- Differences arising on settlement of preferred shares
- Other similar effects of preferred shares classified as equity

D = Weighted average number of ordinary shares outstanding during the period.

Determining the Numerator

14.18 When the entity has preferred shares, it makes the following adjustments to the numerator for preferred share dividends:

- Noncumulative preferred shares: Subtract dividends declared during the period.
- Cumulative preferred shares: Subtract only dividends required during the period, whether or not the entity declared these dividends. In other words, the entity does not adjust profit or loss for dividends declared or paid with respect to dividends required in previous periods.
- Increasing or decreasing rate preferred shares: Subtract or add the amortization of original issue discounts and original issue premiums respectively.

  An entity may also issue *increasing or decreasing rate preferred shares*. Increasing rate preferred shares provide a low initial dividend to compensate the entity for issuing the shares at a discount. Conversely, decreasing rate preferred shares have a high initial dividend and are issued at a premium. Such discounts and premiums are referred to as original issue discount (OID) and *original issue premium* (OIP), respectively and amortized to retained earnings using the effective interest method. The entity treats the amount of the amortization as a preferred share dividend.
- Preferred shares repurchased under a tender offer to holders: Subtract the excess of the fair value of the consideration paid over the carrying amount of the preferred shares.

- Convertible preferred shares: Subtract the excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms.
- Settlement of preference shares: Add any excess of the carrying amount of the preferred shares over the fair value of the consideration paid to settle.

Determining the Denominator

14.19 An entity computes the weighted average number of ordinary shares outstanding during the period as follows:

Date of Event	*Description of the Event*	*Number of Ordinary Shares*	*× Proportion of the Year Remaining*	*= Weighted Average Ordinary Shares Outstanding*
Day 1 of the fiscal year	Beginning balance	Number of shares outstanding at the beginning of the fiscal year	365/365[1]	Beginning balance
Date	Issue of shares	Number of shares issued	Remaining number of days/ 365	Add
Date	Repurchase of shares	Number of shares repurchased	Remaining number of days/ 365	Subtract
Total				Weighted average ordinary shares during the period

[1] Use of ratios based on months is acceptable when the weighted average is not materially different from that calculated using the actual number of days.

14.20 For example, Superlative Millworks (SM), a manufacturing company, has a December 31 fiscal year end. In 2012, SM had 200 ordinary shares outstanding at the end of 2011 and throughout the first quarter of its fiscal year. On the first day of April, SM issued 600 shares for a total of 800 ordinary shares outstanding at the end of that quarter. On October 1, SM repurchased 100 shares. No other transactions in ordinary shares occurred during 201X.

SM determines the weighted average number of the outstanding shares to use in the EPS calculation as follows:

Date	*Description*	*Number of Ordinary Shares*	*× Proportion of the Year Remaining*	*= Weighted Average Ordinary Shares Outstanding*
1/1/201X	Beginning balance	200	365/365 = 12/12	200
4/1/201X	Issue	600	175/365 ≈ 9/12	450
10/1/201X	Repurchase	(100)	92/365 ≈ 3/12	(25)
12/31/201X	Ending balance			625

14.21 Normally, an entity includes shares in the calculation of the weighted average number of ordinary shares that are outstanding as of the date consideration is receivable from an issuance of shares. However, the entity determines the exact date it should include issued shares by reference to the terms and conditions of the relevant contract. For example, an entity includes the following items in the denominator of the EPS calculation as follows:

- Shares issued as part of a business combination—from the date the entity recognizes the business combination in its financial statements.
- Shares issued upon conversion of a mandatorily convertible instrument—from the date the entity enters into the contract.
- Contingently issuable shares—only from the date when all necessary conditions are satisfied (that is, all the contingent events have occurred).

14.22 In addition to share issues and repurchases, an entity also adjusts the denominator in the basic EPS calculation for bonus, capitalization, or consolidation events, such as stock dividends, share splits, or reverse share splits, respectively, as well as other bonus elements, such as those in rights issues.[1] Existing shareholders receive additional shares from these events for no consideration. Therefore, the entity adjusts the denominator of the basic EPS calculation as if the event occurred at the beginning of the fiscal year, rather than the date the event occurs. Paragraphs 14.32–.34 describe these retrospective adjustments in greater detail.

14.23 Refer to paragraph 14.48 for an illustrative example of an entity's quarterly and annual calculations of basic and dilutive EPS.

14.24 Illustrative examples 1–4 that accompany IAS 33 address how to calculate the weighted average number of ordinary shares for the basic EPS calculation and how to include increasing rate preference shares, bonus issues, and rights issues in the weighted average number of ordinary shares calculation.

Diluted Earnings Per Share

14.25 Entities often issue financial instruments that have the potential, if exercised or converted, to change the amount of EPS. Warrants, employee stock options, convertible preferred shares, and convertible bonds are examples of such potential ordinary shares. Existing shareholders are interested in knowing when an entity issues such instruments and understanding what effect these potential ordinary shares may have on their share of profit of loss attributable to their existing holders. Existing shareholders are especially interested if exercise or conversion of potential shares would reduce EPS. Therefore, IAS 33 requires an entity to report a hypothetical calculation of EPS assuming all potential ordinary shares are issued. This hypothetical EPS is referred to as *diluted EPS*.

14.26 Diluted EPS is similar to basic EPS in that it provides information that measures the interest that each ordinary share of the parent has about the entity's profit or loss. However, in contrast to basic EPS, diluted EPS also shows the effect of exercise or conversion of all dilutive potential ordinary shares outstanding during the period. An entity includes in the calculation of diluted EPS only those potential ordinary shares of which conversion or exercise would decrease EPS or increase the per share loss from continuing operations.

14.27 In accordance with paragraph 32 of IAS 33, an entity calculates diluted EPS as follows:

$$\text{Diluted EPS} = \frac{\text{Numerator}}{\text{Denominator}} = \frac{N}{D}$$

Where:

N = Profit or loss attributable to ordinary equity holders of the parent entity used in the calculation of basic EPS adjusted as follows:

- Increase by the after-tax amount of dividends and interest recognized in the period in respect of the dilutive potential ordinary shares

[1] For additional guidance regarding rights issues, refer to paragraph A2 of appendix A, "Application Guide," of International Accounting Standard 33, *Earnings per Share*.

- Increase or decrease for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares

D = Weighted average number of ordinary shares outstanding during the period used in the calculation of basic EPS adjusted as follows:

- Include the additional ordinary shares in the weighted average ordinary share calculation depending upon the date of issue as follows:
  - If on or before the beginning of the period: Include additional shares at the beginning of the period.
  - If issued during the period: Include additional shares as of the date of issue.

14.28 IAS 33 provides the following additional guidance on calculation of the weighted average number of ordinary shares that an entity includes in the diluted EPS calculation:

- Determine the number of dilutive potential ordinary shares independently for each period presented.
- Calculate the number of dilutive potential ordinary shares included in the year-to-date calculation directly. Do not use a weighted average of the dilutive potential ordinary shares included in the interim calculations.
- Weight potential ordinary shares for the period they are outstanding. For example, the following potential ordinary shares only for a portion of the period as follows:
  - Include any potential ordinary shares that an entity cancels or allows to lapse during the period only for the period these share are outstanding.
  - Include potential ordinary shares that are converted during the period only from the beginning of the period to the date of conversion. (These shares would be included in the calculations of both basic and diluted EPS from the date of conversation to the end of the period.)
- Determine the number of ordinary shares that would be issued based on the terms of the relevant contract.
- Use the most advantageous existing conversion rate or exercise price from the perspective of the holder of the potential shares. Do not use the perspective of the entity in determining the rate to use.
- Include potential ordinary shares of associates, a subsidiaries, or joint ventures that have a dilutive effect on basic EPS of the reporting entity.

14.29 For example, the entity will make the following adjustments and assumptions when including the effects of dilutive potential ordinary shares in its EPS calculation:

- Convertible instruments—The entity adjusts the numerator for the after tax effect of dividends declared or interest expense.
- Options, warrants, and their equivalents—The entity assumes it will use the proceeds from exercise to repurchase its own ordinary shares at the average market price during the period. Refer to paragraphs A4–A5 of appendix A of IAS 33 for additional guidance regarding the average market price of ordinary shares.
- Contingently issuable shares—The entity treats these shares as ordinary shares in both basic and dilutive EPS calculations from the date the conditions and terms of the contingency are met.

14.30 An entity does not include antidilutive potential ordinary shares in the EPS calculation. Potential ordinary shares are antidilutive when conversion would either increase EPS or cause a reduction in the loss per share from continuing operations. An example of antidilutive potential ordinary shares is a purchased put option on the entity's own shares that are held by the entity. A buyer of a put option believes that the underlying share price will fall by the exercise date. By purchasing a put option on its own shares, the entity, believing that its share price will fall, hopes to minimize any loss it experiences when it reissues treasury stock. The purchased option is antidilutive because the entity would only exercise the put option when the exercise price is greater than the market price. The methodology for including such options in the EPS calculation requires the entity to assume, hypothetically, that it will use the proceeds from the issue of shares to the seller of the put option to repurchase its own shares. Because the proceeds per share exceed the market price per share, the entity will be able to repurchase more shares than it issued. Therefore, the number of weighted average ordinary shares outstanding will decrease and EPS will increase.

14.31 Refer to paragraph 14.48 for an illustrative example of an entity's quarterly and annual calculations of basic and dilutive EPS.

14.32 Refer to paragraphs A11–A12 of appendix A of IAS 33 for additional guidance about how to include dilutive potential ordinary shares of a subsidiary, joint venture, or associate in the calculation of the reporting entity's diluted EPS. In addition, illustrative example 10 in IAS 33 provides an example of instruments of a subsidiary's calculation of both basic and diluted EPS.

14.33 The illustrative examples in IAS 33 include examples of how an entity should treat the following issues in the calculation of diluted EPS:

- Share options
- Exercise price of employee share options
- Convertible bonds
- Contingently issuable shares
- Convertible bonds settled in shares or cash at the issuer's option
- The order in which to include dilutive instruments in the calculation of weighted average number of ordinary shares

Retrospective Adjustments

14.34 As noted previously, bonus and capitalization events, such as stock dividends and stock splits, and consolidation events, such as reverse share splits, increase or decrease, respectively, the number of ordinary or potential ordinary shares outstanding. As a result, IAS 33 requires an entity to adjust both basic and diluted EPS retrospectively for all periods presented.

14.35 Sometimes capitalization and consolidation events happen after the end of the reporting period. If the financial statements have not been authorized for issue, the entity should base its EPS calculations on the new number of shares reflecting the capitalization or consolidation changes for all periods presented. An entity should also disclose the fact that the per share calculations incorporate these changes to the number of shares used to calculate EPS.

14.36 An entity also retrospectively adjusts its EPS calculation for all periods presented for changes in accounting policy or error corrections. However, an entity does not restate diluted EPS presented in prior periods for changes in the assumptions used to calculate EPS or for the conversion of potential ordinary shares to ordinary shares.

Presentation

14.37 IAS 33 requires an entity to present basic and diluted EPS for every period in which it presents a statement of profit or loss and other comprehensive income, even if those EPS amounts are negative, representing a loss per share. The entity should present basic and diluted EPS with equal prominence for all of the periods presented. Basic and diluted EPS sometimes are the same amount; in which case, the entity can use a dual presentation including both on one line in the statement of profit or loss and other comprehensive income. If an entity reports diluted EPS for any period presented, it should report diluted EPS for all periods.

14.38 An entity includes all of the following per share amounts in the presentation of basic and diluted EPS:

- Profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity
- Profit or loss attributable to the ordinary equity holders of the parent entity
- The period for each class of ordinary shares that has a different right to share in the profit for the period

14.39 When an entity reports a discontinued operation, it should also present per share amounts of both basic and diluted EPS for the discontinued operation either in the statement of profit or loss and other comprehensive income or in the notes to the financial statements.

Disclosure

14.40 When presenting EPS, the entity should provide the following disclosures for both basic and diluted EPS:

- Amounts used as the numerators in each of the EPS calculations, with reconciliation of those amounts to profit or loss attributable to the parent entity for the period
- Weighted average number of ordinary shares used as denominators in the EPS calculations with a reconciliation from one denominator to the other

The entity includes in both of these disclosures the individual effect that each class of equity instruments had on EPS.

14.41 IAS 33 requires an entity to disclose any antidilutive equity instruments that it did not include in the calculation of diluted EPS for each period presented. Such antidilutive instruments include contingently issuable shares that could potentially dilute basic EPS in the future.

14.42 Entities should disclose a description of ordinary or potentially ordinary shares transactions that occurred after the reporting period when these transactions would have significantly changed the number of outstanding ordinary or potentially ordinary shares at the end of the period had they occurred during the period.

14.43 As described previously in this chapter, an entity does not retrospectively adjust EPS for bonus, capitalization, and consolidation transactions, which occur after the end of the period. These transactions do not affect the amount of capital that was used to generate profit or loss for the reporting period.

14.44 Some examples of transactions occurring after the end of the period that could potentially require disclosure include the following:

- Shares issued for cash or when the proceeds from the issuance are used to repay debt or preference shares outstanding at the end of the reporting period
- Redemption of ordinary shares outstanding
- Exercise or conversion of potential ordinary shares outstanding at the end of the reporting period into ordinary shares
- Issue of convertible instruments, warrants, or options
- Fulfillment of conditions that result in the entity issuing contingent shares

14.45 Paragraph 72 of IAS 33 explains that some financial instruments and other contracts generating potential ordinary shares may include terms and conditions that affect the measurement of basic and diluted EPS. These terms and conditions affect whether potential ordinary shares are dilutive and, if so, the effect on both the calculation of the weighted average number of ordinary shares outstanding and profit or loss attributable to ordinary equity holders. IFRS 7, *Financial Instruments: Disclosures*, requires the disclosure of certain terms and conditions of contracts or financial instruments, but if not otherwise required, IAS 33 encourages the disclosure of such terms and conditions.

14.46 Sometimes an entity discloses amounts per share based on a component of the statement of profit or loss and other comprehensive income or a separate income statement as described in paragraph 81A of IAS 1, which is different from the required EPS disclosures. In this case, the entity should also disclose the following:

a. Amounts calculated by using the same weighted average number of ordinary shares that were used to calculate the required EPS disclosures

b. Basic and diluted per share amounts relating to the component that are disclosed with equal prominence and presented in the notes to the financial statements

c. Basis for the shares used in the numerator to arrive at the per share amount

d. Whether the calculated per share amounts are before or after income tax

14.47 When an entity uses a component of the statement of profit or loss and other comprehensive income that is not a reported line item in that statement, the entity should also provide reconciliation between the amount of the component and a line item reported in the statement of profit or loss and other comprehensive income.

Examples of EPS Calculations

Use of the Control Number

14.48 Paragraphs 42–43 of IAS 33 introduce the notion of a *control number,* an amount against which the entity would assess whether the change in EPS is dilutive or antidilutive. IAS 33 states that an entity uses profit or loss from continuing operations as this control number. The following example is an excerpt from paragraph A3 of appendix A of IAS 33 and illustrates the application of this notion.

Example 14-1

Data

Assume an entity reports the following information:

1.	Profit from continuing operations attributable to the parent entity	Currency units (CU) 4,800
2.	Loss from discontinued operations attributable to the parent entity	(CU 7,200)
3.	Net loss attributable to the parent entity	(CU 2,400)
4.	Ordinary shares outstanding	2,000 shares
5.	Potential ordinary shares outstanding	400 shares

Analysis

Calculations of basic EPS:

1.	Profit from continuing operations / Ordinary shares outstanding	=	CU 4,800 / 2,000 shares	=	CU 2.40
2.	Loss from discontinued operations / Ordinary shares outstanding	=	(CU 7,200) / 2,000 shares	=	(CU 3.60)
3.	Net loss / Ordinary shares outstanding	=	(CU 2,400) / 2,000 shares	=	(CU 1.20)

Calculations of diluted EPS:

4.	Profit from continuing operations / Ordinary + potential shares outstanding	=	CU 4,800 / 2,400 shares	=	CU 2.00
Note:	Profit from continuing operations is the control number.				
	Basic EPS from continuing operations			=	CU 2.40
	EPS after adding potential ordinary shares			=	CU 2.00

EPS from continuing operations (control number) decreased after the entity added the potential ordinary shares outstanding (CU 2.00 < CU 2.40). Therefore, the potential ordinary shares are dilutive and the entity includes these shares in its calculation of diluted EPS, even when the entity reports a net loss.

5.	Loss from discontinued operations / Ordinary + potential shares outstanding	=	(CU 7,200) / (CU 3.00)	=	2,400 shares
6.	Net loss / Ordinary + potential shares outstanding	=	(CU 2,400) / 2,400 shares	=	(CU1.00)

Written Put Options

14.49 The following example from paragraph A10 of appendix A of IAS 33 illustrates the adjustment to the diluted EPS calculation when the entity has written a put option on its own shares. In calculating diluted EPS, the entity should assume that the buyer will exercise the put option at the earlier of the beginning of the period or date on which the put option was written.

Example 14-2

Data

Assume the entity reports the following information:

1.	The entity wrote put options on entity's ordinary shares	120
2.	Exercise price per put option	CU 35
3.	Average market price per ordinary share during the period	CU 28

Analysis

IAS 33 requires the entity to determine the incremental shares it will issue assuming that the buyer exercises the put options at the beginning of the period, regardless of the relationship between the exercise price and the market price of its ordinary shares. The entity calculates the effect of exercise as follows:

1. Calculate the entity's required payment to the buyer in exchange for 120 shares at the exercise price of CU 35.

Required payment to buyer	=	Put options	×	Exercise price
	=	120	×	CU 35
	=	CU 4,200		

2. Calculate the number of shares the entity would need to issue to receive the required payment of CU 4,200. (IAS 33 requires the entity to assume that it would issue shares to generate the cash required to satisfy this obligation.)

Number of shares issued	=	Required payment	÷	Average market price per share
	=	CU 4,200	÷	CU 28
	=	150 shares		

3. Calculate the incremental shares issued.

Number of shares issued	150
Less: Number of shares delivered to holder of put options	(120)
Incremental shares issued	30

4. Add the number of incremental shares issued to denominator when calculating diluted EPS.

Calculation and Presentation of Basic and Diluted EPS—Illustrative Example

14.50 The following is a comprehensive example of the calculation and presentation of basic and diluted EPS. This example includes preferred shares, preferred share dividends, warrants, and stock options. (Refer to example 12 in the illustrative examples of IAS 33.)

Example 14-3

Facts

- Company A has a complex capital structure and a calendar year fiscal year end.
- Profit or loss from continuing operations attributable to the parent's entity is used at the control number for determining whether a potential ordinary share is dilutive or antidilutive.
- Average market price of ordinary shares during 2011 were as follows:

First quarter	CU 49
Second quarter	CU 60
Third quarter	CU 67
Fourth quarter	CU 67

The average market price of ordinary shares from 1 July to 1 September, 2011, was CU 65.

- Number of ordinary shares outstanding:

January 1, 2011	Beginning balance	5,000,000
March 1, 2011	Issued for cash	200,000

- Convertible bonds:

In the last quarter of 2010, the entity issued 5 percent convertible bonds at par:

Face value:	CU 1,000 each
Maturity:	20 years
Proceeds:	CU 12,000,000

Interest is payable twice a year, on 1 November and 1 May.
Each CU 1,000 bond is convertible into 40 ordinary shares.
No bonds were converted in 2010.
The entire issue was converted on April 1, 2011, because the issue was called by Company A.

- Convertible preference shares:

In the second quarter of 2009, the entity issued 800,000 convertible preferred shares for assets acquired in a purchase transaction.

Dividend per share:	CU 0.05
Dividend frequency:	Quarterly, at the end of the quarter, on shares outstanding at that date.
Conversion ratio:	1 ordinary share for 1 convertible preference share.

Holders of 600,000 convertible preference shares converted their preference shares into ordinary shares on June 1, 2011.

- Warrants:

The entity issued warrants on January 1, 2011:

Number of shares:	600,000 ordinary shares
Exercise price per share:	CU 55
Period:	5 years

All outstanding warrants were exercised on September 1, 2011.

- Options:

The entity issued stock options on July 1, 2011

Number of shares:	1,500,000 ordinary shares
Exercise price per share:	CU 75
Period:	10 years

No options were exercised during 2011 because the exercise price of the options exceeded the market price of the ordinary shares.

- Tax rate:
  The tax rate was 40 percent during 2011.

2011	*Profit (loss) from continuing operations attributable to the parent entity CU*	*Total profit (loss) attributable to the parent entity CU*
First quarter	5,000,000	5,000,000
Second quarter	6,500,000	6,500,000
Third quarter	1,000,000	(1,000,000)
Fourth quarter	(700,000)	(700,000)
Full year	11,800,000	9,800,000

1st Quarter 2011

Calculation of Basic EPS

1st Quarter

$$\text{Basic EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 4{,}960{,}000}{5{,}066{,}667} = \text{CU } 0.98$$

	CU
Numerator—Profit from continuing operations attributable to ordinary shareholders of parent entity	
Profit from continuing operations attributable to shareholders of Company A (control number)	5,000,000
Less: Preference share dividends	(40,000)
Profit from continuing operations attributable to ordinary shareholders of Company A	**4,960,000**

Denominator—Weighted Average Ordinary Shares Outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period remaining*[1]	*Weighted average shares*
January 1	Beginning balance	5,000,000	3/3	5,000,000
March 1	Issue of ordinary shares	200,000	1/3	66,667
March 31	**Weighted-average shares**	**5,200,000**		**5,066,667**

[1] There is more than one method for calculating the weighted average number of shares outstanding for basic EPS. This method looks at the fraction of the period remaining for each event listed. For each quarter, there are three months in the quarter and fractions are calculated based on a denominator of three. For example, the issue of ordinary shares occurred on March 1, there is one month remaining in the quarter after that event.

Calculation of Diluted EPS

1st Quarter

$$\text{Diluted EPS} = \frac{\text{Adjusted profit from continuing operations}}{\text{Adjusted weighted average shares}} = \frac{\text{CU } 5{,}090{,}000}{6{,}346{,}667} = \text{CU } .80$$

	CU
Numerator—Adjusted profit from continuing operations attributable to ordinary shareholders of the parent entity	
Numerator used for the Basic EPS calculation	4,960,000
Plus: Preferred share dividends (assume converted at January 1)[1]	40,000
Plus: 3 months after-tax interest on 5 percent convertible bonds[2] (assume converted at January 1) (CU 12,000,000×.05×.60) ÷ 3 =	90,000
Adjusted profit from continuing operations	5,090,000

[1] 800,000 preferred shares outstanding during the quarter × CU 0.05 = CU 40,000 in 1st quarter.

[2] Par value of the 5 percent convertible bonds = CU 12,000,000. Because the tax rate is 40 percent, the entity will keep (1-tax rate) or 60 percent of the increase in income. Therefore, if the bonds were converted at January 1, the adjustment to profit is: CU 12,000,000 × 0.05 × 0.60 = CU 90,000.

Denominator—Adjusted Weighted Average Ordinary Shares Outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period until conversion or exercise*	*Weighted average shares*
	Weighted average shares from basic EPS calculations	5,200,000		5,066,667
Adjustments for potential ordinary shares outstanding				
	Warrants (antidilutive)[1]			0
	Convertible preferred shares (assume converted on January 1)	800,000	3/3	800,000
	5% convertible bonds[2] (Assume converted on January 1)	480,000	3/3	480,000
	Options (antidilutive)[3]			0
	Adjusted weighted average shares			6,346,667
	Diluted EPS			

[1] Warrants are antidilutive because the market price is CU 49 during the 1st quarter, which is less than the exercise price of CH55. Company A could repurchase more stock with the proceeds from exercise than it would need to issue so that the weighted average common shares outstanding would decrease, therefore increasing EPS.

[2] Total par value ÷ Par value per bond = Number of bonds issued

CU 12,000,000 ÷ CU 1,000 = 12,000 bonds

Conversion rate = 40 shares/bond

Total number of additional shares = 12,000 bonds × 40 shares/bond = 480,000 shares

[3] Options are antidilutive throughout 2011 because the exercise price of CU 75 exceeds the highest average market price of CU 67. Therefore, there is no adjustment to the weighted average ordinary shares outstanding during any period in 2011.

2nd Quarter 2011

Calculation of Basic EPS

2nd Quarter

$$\textbf{Basic EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 6{,}490{,}000}{5{,}880{,}000} = \textbf{CU 1.10}$$

	CU
Numerator—Profit from continuing operations attributable to ordinary shareholders of parent entity	
Profit from continuing operations attributable to the parent entity	6,500,000
Less: Preference share dividends	(10,000)
Profit from continuing operations attributable to ordinary shareholders of the parent entity	**6,490,000**

Denominator—Weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period remaining*	*Weighted average shares*
April 1	Balance – end of 1st quarter	5,200,000	3/3	5,200,000
April 1	Conversion of 5% bonds	480,000	3/3	480,000
June 1	Conversion of preferred shares	600,000	1/3	200,000
June 30	**Weighted-average shares**	**6,280,000**		**5,880,000**

Calculation of Diluted EPS

2nd Quarter	**Diluted EPS**	=	Adjusted profit from continuing operations / Adjusted weighted average shares	=	CU 6,500,000 / 6,530,000	=	**CU 1.00**

	CU
Numerator—Adjusted profit from continuing operations attributable to ordinary shareholders of the parent entity	
Numerator used for the basic EPS calculation	6,490,000
Plus: Preference share dividends[1]	10,000
Plus: After-tax interest on 5% convertible bonds[2]	
Company A paid no interest in 2nd quarter because bonds converted on April 1.	0
Adjusted profit from continuing operations	**6,500,000**

[1] 600,000 of the 800,000 preferred shares converted on June 1. Therefore, Company A only paid dividends in the 2nd quarter on 200,000 shares: 05 × 200,000 = CU 10,000.

[2] Company A paid no interest in 2nd quarter because bonds converted on April 1.

Denominator—Adjusted weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period until conversion or exercise*	*Weighted average shares*
	Weighted average shares from basic EPS calculation[1]			5,880,000
Adjustments for	potential ordinary shares outstanding			
	5% convertible bonds	0		0
	Convertible preferred shares[2]	600,000	2/3	400,000
	Convertible preferred shares	200,000	3/3	200,000
	Warrants[3]	50,000	3/3	50,000
	Weighted average shares—diluted EPS			6,530,000

[1] 5 percent convertible bonds converted on April 1, beginning of 2nd quarter. The effect of this conversion is already included in the weighted average shares from the basic EPS calculation.

[2] Convertible preferred shares:

		Fraction of 2nd quarter until conversion
Outstanding on April 1	800,000	
Converted on June 1	(600,000)	2/3
Outstanding on June 30	200,000	3/3

[3] Because the market price of Company A's share rose to CU 60 in the 2nd quarter, which is greater than the exercise price of the warrants, the warrants are dilutive in the 2nd quarter.

Proceeds from exercise (CU 55 × 600,000 shares)	CU 33,000,000
Shares issued to warrant holders	600,000
Less: Shares repurchased with proceeds (CU 33,000,000 ÷ CU 60)	(550,000)
Incremental number of shares issued	50,000

3rd Quarter 2011

Calculation of Basic EPS

3rd Quarter

$$\textbf{Basic EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 990{,}000}{6{,}480{,}000} = \textbf{CU 0.15}$$

$$\textbf{Basic EPS} = \frac{\text{Loss from discontinued operations}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 2{,}000{,}000)}{6{,}480{,}000} = \textbf{(CU 0.31)}$$

$$\textbf{Basic EPS} = \frac{\text{Net loss}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 990{,}000}{6{,}480{,}000} = \textbf{(CU 0.16)}$$

	CU
Numerator—Profit from continuing operations attributable to ordinary shareholders of Company A	
Profit from continuing operations attributable to Company A	1,000,000
Less: Preference share dividends	(10,000)
Profit from continuing operations attributable to ordinary shareholders of the parent entity	**990,000**
Loss from discontinued operations attributable to the shareholders of the parent entity	**(2,000,000)**
Net loss attributable to the attributable to the shareholders of the parent entity	**(1,010,000)**

Denominator—Weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period remaining*	*Weighted average shares*
July 1	Balance—End of 2nd quarter	6,280,000	3/3	6,280,000
September 1	Exercise of warrants	600,000	1/3	200,000
September 30	**Weighted-average shares**	**6,880,000**		**6,480,000**

Calculation of Diluted EPS

3rd Quarter

$$\textbf{Diluted EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 1{,}000{,}000}{6{,}741{,}538} = \textbf{CU 0.15}$$

$$\textbf{Diluted EPS} = \frac{\text{Loss from discontinued operations}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 2{,}000{,}000)}{6{,}741{,}538} = \textbf{(CU 0.30)}$$

$$\textbf{Diluted EPS} = \frac{\text{Net loss}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 1{,}000{,}000)}{6{,}741{,}538} = \textbf{(CU 0.15)}$$

	CU
Numerator—Adjusted profit from continuing operations attributable to ordinary shareholders of the parent entity	
Numerator used for the basic EPS calculation (control number)	990,000
Plus: Preference share dividends[1]	10,000
Adjusted profit from continuing operations	**1,000,000**
Loss from discontinued operations attributable to the shareholders of the parent entity	**(2,000,000)**
Net loss attributable to the attributable to the shareholders of the parent entity	**(1,000,000)**

[1] 600,000 of the 800,000 preferred shares converted on June 1. Therefore, Company A only paid dividends in the 3rd quarter on 200,000 shares: .05 × 200,000 = CU 10,000.

Denominator—Adjusted weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period until conversion or exercise*	*Weighted average shares*
	Weighted average shares from basic EPS calculation[1]			6,480,000
Adjustments for	potential ordinary shares outstanding			
	Convertible preferred shares	200,000	3/3	200,000
	Exercise of warrants[2]	92,308	2/3	61,538
	Weighted average shares—Diluted EPS			6,741,538

[1] Only 200,000 of the convertible preferred shares are outstanding the entire 3rd quarter.

[2] Because the average market price of Company A's shares is CU 65 from July 1 to September 1, which is greater than the exercise price of the warrants, the warrants are dilutive in the 2nd quarter.

Proceeds from exercise (CU 55 × 600,000 shares)	CU 33,000,000
Shares issued to warrant holders	600,000
Less: Shares repurchased with proceeds (CU 33,000,000 ÷ CU 66)	(507,692)
Incremental number of shares issued	92,308

4th Quarter 2011

Calculation of Basic EPS

4th Quarter

$$\textbf{Basic EPS} = \frac{\text{Loss from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 710{,}000)}{6{,}880{,}000} = \textbf{CU 0.10}$$

	CU
Numerator—Profit from continuing operations attributable to ordinary shareholders of parent entity	
Loss from continuing operations attributable to Company A (control number)	(700,000)
Less: Preference share dividends	(10,000)
Loss from continuing operations attributable to ordinary shareholders of the parent entity	**(710,000)**

Denominator—Weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period remaining*	*Weighted average shares*
October 1	Balance—End of 3rd quarter	6,880,000	3/3	6,880,000
December 31	**Weighted-average shares**	**6,880,000**		**6,880,000**

Note: No potential ordinary shares were exercised or converted in the 4th quarter.

Calculation of Diluted EPS

4th Quarter

$$\textbf{Diluted EPS} = \frac{\text{Adjusted profit from continuing operations}}{\text{Adjusted weighted average shares}} = \frac{(\text{CU } 710{,}000)}{6{,}880{,}000} = \textbf{CU 0.10}$$

	CU
Numerator—Adjusted loss from continuing operations attributable to ordinary shareholders of the parent entity	
Numerator used for the basic EPS calculation	(710,000)
Adjustments[1]	0
Adjusted loss from continuing operations	**(710,000)**

[1] The loss from continuing operations attributable to the shareholders of Company A, the control number, is negative in the 4th quarter. Therefore, Company A does not adjust the control number because any adjustment would be antidilutive; that is, adding the preferred share dividends from the remaining convertible preferred shares would decrease the loss.

Denominator—Adjusted weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period until conversion or exercise*	*Weighted average shares*
October 1	Weighted average shares from basic EPS calculation[1]	6,880,000	3/3	6,880,000
	Adjustments	0		0
December 31	Weighted average shares—Diluted EPS			6,880,000

[1] Incremental shares from assumed conversions are not included in calculating diluted EPS because the control number (loss from continuing operations attributable to ordinary shareholders of Company A) is negative. Any increase in weighted average common shares outstanding from dilutive potential ordinary shares would decrease the loss per share and effectively be antidilutive.

Full Year 2011

Calculation of Basic EPS

2011

$$\textbf{Basic EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 11{,}730{,}000}{6{,}076{,}667} = \textbf{CU 1.93}$$

$$\textbf{Basic EPS} = \frac{\text{Loss from discontinued operations}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 2{,}000{,}000)}{6{,}076{,}667} = \textbf{(CU 0.33)}$$

$$\textbf{Basic EPS} = \frac{\text{Net loss}}{\text{Weighted average shares outstanding}} = \frac{9{,}730{,}000}{6{,}076{,}667} = \textbf{CU 1.60}$$

	CU
Numerator—Profit from continuing operations attributable to ordinary shareholders of Company A	
Profit from continuing operations attributable to Company A	11,800,000
Less: Preference share dividends[1]	(70,000)
Profit from continuing operations attributable to ordinary shareholders of the parent entity	**11,730,000**
Loss from discontinued operations attributable to the shareholders of the parent entity	**(2,000,000)**
Net loss attributable to the attributable to the shareholders of the parent entity	**(9,730,000)**

[1] Company A paid preferred share dividends as follows:

1st Quarter	800,000 shares × CU 0.05	= CU 40,000
2nd Quarter	200,000 shares × CU 0.05	= CU 10,000
3rd Quarter	200,000 shares × CU 0.05	= CU 10,000
4th Quarter	200,000 shares × CU 0.05	= CU 10,000
Total preferred share dividends paid in 2011		CU 70,000

Denominator—Weighted average ordinary shares outstanding

Dates	*Description*	*Shares outstanding*	*Fraction of period remaining*	*Weighted average shares*
January 1	Beginning balance	5,000,000	12/12	5,000,000
March 1	Issue of ordinary shares	200,000	10/12	166,667
April 1	Conversion of 5% convertible bonds	480,000	9/12	360,000
June 1	Conversion of preferred shares	600,000	7/12	350,000
September 1	Exercise of warrants	600,000	4/12	200,000
December 31	**Weighted average shares**	**6,880,000**		**6,076,667**

Note: See the relevant quarter for calculation of the additional shares outstanding on conversion or exercise of the convertible bonds, preferred shares, and warrants.

Calculation of Diluted EPS

2011

$$\textbf{Diluted EPS} = \frac{\text{Profit from continuing operation}}{\text{Weighted average shares outstanding}} = \frac{\text{CU } 11{,}730{,}000}{6{,}661{,}547} = \textbf{CU 1.78}$$

$$\textbf{Diluted EPS} = \frac{\text{Loss from discontinued operations}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 2{,}000{,}000)}{6{,}661{,}547} = \textbf{(CU 0.30)}$$

$$\textbf{Diluted EPS} = \frac{\text{Net loss}}{\text{Weighted average shares outstanding}} = \frac{(\text{CU } 9{,}730{,}000)}{6{,}661{,}547} = \textbf{CU 1.48}$$

	CU
Numerator—Adjusted profit from continuing operations attributable to ordinary shareholders of the parent entity	
Numerator used for the basic EPS calculation (control number)	11,730,000
Plus: Preference share dividends[1]	70,000
Plus: After-tax interest on 5% convertible bonds[2]	90,000
Adjusted profit from continuing operations	**11,890,000**
Loss from discontinued operations attributable to the shareholders of the parent entity	**(2,000,000)**
Net loss attributable to the attributable to the shareholders of the parent entity	**(9,890,000)**

[1] See calculation of preferred share dividends paid in the calculation of the numerator of basic EPS.

[2] Company A called the 5 percent convertible bonds on April 1. Therefore, the adjustment for the after-tax amount of interest paid during 2011 is as follows:

Par value of bond Issue × Interest rate × Fraction of year × (1-tax rate) = After-tax interest paid

CU 12,000,000 × 0.05 × 3/12 × (1 − 0.40) = CU 90,000

Denominator—Adjusted weighted average ordinary shares outstanding

Dates of exercise or conversion	*Description*	*Shares outstanding*	*Fraction of period until conversion or exercise*	*Weighted average shares*
	Weighted average shares from basic EPS calculation[1]			**6,076,667**
April 1	5% convertible bonds[1]	480,000	3/12	120,000
June 1	Convertible preferred shares[2]	600,000	5/12	250,000
Not converted	Convertible preferred shares[2]	200,000	12/12	200,000
September 1	Warrants[3]	22,320	2/3	14,880
	Weighted average shares—Diluted EPS			6,661,547

[1] All 480,000 of the 5 percent convertible bonds converted on April 1. From April 1, the additional ordinary shares are included in the basic EPS calculation. Therefore, the adjustment for assumed conversion is for the 3 months prior to April 1.

[2] Only 600,000 of the 800,000 convertible preferred shares converted on June 1. Therefore, Company A adjusts the denominator for assumed conversion separately for the shares that converted and those that did not. The incremental shares issued on conversion of the 600,000 shares that converted on June 1 are included in the calculation of basic EPS from that date.

[3] With respect to the warrants, Company A first calculates the average market price of its ordinary shares for the period January 1 to September 1, the date of exercise, as follows:

Period	*Average price*	*Number of months*	*Sum of monthly price*
1st quarter	CU 49	3	CU 147
2nd quarter	60	3	180
July & August	65	2	130
Total		8	CU 457

Average market price per month over January 1–September 1
= Sum of monthly prices ÷ 8 months
= CU 457/8 months = CU 57.125

Proceeds from issue of shares at exercise = CU 55 × 600,000 warrants =	CU 33,000,000
Number of shares issued =	600,000
Less: Shares repurchased = CU 33,000,000 ÷ CU 57.125 =	(577,680)
Incremental shares issued	22,320

Chapter 15

Statement of Cash Flows

Overview

15.01 The objective of general purpose financial reporting, as described in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*, is to provide information about the reporting entity that is useful to investors and creditors in making decisions about providing resources to the entity. These users' expectations about returns from an entity's equity and debt instruments depend on their ability to assess the amount, timing, and uncertainty of, and prospects for, future net cash inflows to the entity. Consequently, existing and potential investors and creditors need information that help them make this assessment. The entity's cash flow statement provides some of the needed information about an entity because it allows financial statement users to better evaluate the following:

- The origin of an entity's cash inflows and outflows
- Its ability to do the following:
  - Generate sufficient cash and cash equivalents
  - Maintain operating capability
  - Meet their obligations
  - Provide returns on investment to investors
  - Make new investments without seeking external financing sources
- Changes in the entity's net assets
- The entity's liquidity and solvency
- Differences between the entity's cash receipts and disbursements and their profit and loss
- The type of cash and noncash transactions entered into by the entity

15.02 The statement of cash flows eliminates or reduces the effects of different accounting treatments for the same transactions. Therefore, it improves comparability of entities' financial position and financial performance across types of entities and industries.

Summary of Selective Accounting Guidance

15.03 The primary accounting guidance that describes presentation and disclosure of information in the statement of cash flows is International Accounting Standard (IAS) 7, *Statement of Cash Flows*. IAS 1, *Presentation of Financial Statements*, described in chapter 2," The Conceptual Framework and Financial Statement Presentation," of this book requires that a complete set of financial statements include a statement of cash flows for each period for which the entity presents financial statements.

Scope

15.04 IAS 7 applies to all entities. Both IAS 1 and IAS 7 require an entity to present a statement of cash flows as an integral part of its complete set of financial statements, prepared in accordance with IAS 7, for each period for which it presents financial statements. Refer to chapter 2 of this book for guidance about the requirements of IAS 1 for preparation and presentation of financial statements in general.

Presentation

15.05 In the statement of cash flows, an entity should report its cash flows and the inflows and outflows of cash and cash equivalents, during the period classified, into the following three types of activities:

- Operating
- Investing
- Financing

15.06 Classification of cash flows by activity provides financial statement users information that allows them to assess the effect of these activities on the entity's financial position and on the amount of cash and cash equivalents and to evaluate relationships among these activities.

15.07 Cash flows from a single transaction may result from more than one type of activity. For example, a repayment of an obligation may include cash flows for both principal and interest. Although an entity would classify the principal repayment as a financing activity, it could choose to classify the interest payment as an operating activity. Additionally, the entity may consider a gain or loss from the sale of property, plant, and equipment (PP&E) as operating income on the statement of profit or loss and other comprehensive income. The entity would classify any cash proceeds from the sale as an investing activity.

15.08 Refer to the illustrative examples that accompany IAS 7 for examples of presentation and disclosure examples for both financial institutions and other entities.

Cash and Cash Equivalents

15.09 The statement of cash flows reports changes in an entity's cash and cash equivalents during a period. Paragraph 6 of IAS 7 defines the following terms:

- *Cash* is cash on hand and demand deposits.
- *Cash equivalents* are short-term, highly liquid investments, readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Examples of cash equivalents generally include Treasury bills, commercial paper, and money market instruments.

15.10 Entities use cash equivalents to meet short-term cash commitments, rather than for investment or other purposes. Cash equivalents are short-term in nature, with a maturity of three months or less from the date of acquisition. An entity normally excludes the following from classification as a cash equivalent:

- Equity investments
- Bank borrowings

15.11 However, IAS 7 does not prohibit an entity from classifying these instruments as cash equivalents. An entity may classify an equity investment as a cash equivalent when it is, in substance, a cash equivalent. For example, an entity may classify an investment in preferred shares as a cash equivalent if the shares have a specified redemption date and the entity acquired those shares within a short period of that date. Similarly, although bank borrowings are normally financing activities, some borrowings, such as bank overdrafts, which are repayable on demand and are used as a normal part of the entity's cash management function, can be considered cash equivalents in these circumstances. Paragraph 8 of IAS 7 identifies a fluctuating bank balance between positive and overdrawn as a key characteristic of borrowings that an entity could classify as a cash equivalent.

15.12 An entity should consider movements between items classified as cash and cash equivalents as part of an entity's cash management activities. Therefore, the entity does not include these movements in its operating, investing, and financing activities.

15.13 An entity should disclose the components of cash and cash equivalents and present a reconciliation of the amounts reported in the statement of financial position to the equivalent amounts reported in the statement of cash flows. An entity should also disclose, and comment on, the amount of significant balances held by an entity that are not available for use by the group. The following is an example of these required disclosures.

	2012	2011
	Currency unit	
Cash on hand and balances with banks	(CU) 40	CU 25
Short-term investments	190	135
Cash and cash equivalents as previously reported	230	160
Effect of exchange rate changes	—	(40)
Cash and cash equivalents as restated	CU 230	CU 120

15.14 Cash and cash equivalents at the end of the period include deposits with banks of CU 100 held by a subsidiary that are not freely remissible to the holding company because of currency restrictions.

Investing Activities

15.15 IAS 7 defines *investing activities* as the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Therefore, cash flows from investing activities represent the extent to which expenditures have been made for resources intended to generate income and cash flows for several reporting periods in the future. An entity can only classify expenditures that result in the entity recognizing an asset in the statement of financial position as investing cash flows; that is, cash outflows to acquire assets, and cash inflows from the sale of assets. Some examples of cash flows arising from investing activities are

- cash outflows for the acquisition and cash inflows from disposal of noncurrent assets, such as PP&E.
- cash outflows for the acquisition of investments in joint ventures, associates (except when held for trading purposes and considered cash equivalents), and through business combinations.
- cash receipts from sales of self-constructed PP&E.
- cash receipts from sales of intangible assets.
- cash advances and loans made to other parties (except those by financial institutions).
- cash receipts from or payments for future, forward, option, and swap contracts (except when the contracts are held for trading purposes or classified as financing activities).

15.16 Cash flows from purchases and sales of assets classified as inventory are not investing cash flows.

15.17 An entity should classify cash flows from contracts accounted for as a hedge of an identifiable position in the same manner as the cash flows of the position being hedged.

15.18 An entity should report cash flows from investing activities by major class of gross cash receipts and gross cash payments, unless it qualifies for a net presentation.

Financing Activities

15.19 IAS 7 defines *financing activities* as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. Cash flows from financing activities assist users of the financial statements to predict claims by providers of debt and equity capital to the entity on the entity's future cash flows. Some examples of cash flows from financing activities include the following:

- Cash proceeds from the issuance of shares or the cash payments to repurchase of shares
- Cash proceeds and cash payments of principal on borrowings, including payments by a lessee relating to the reduction of an outstanding finance lease obligation
- Cash proceeds from employees exercising share options
- Cash proceeds on the sale or cash repurchases of treasury stock

15.20 Entities should report cash flows from financing activities by major class of gross proceeds and gross cash payments unless the entity qualifies for net presentation.

Operating Activities

15.21 *Operating activities* are primarily derived from an entity's principal revenue-producing activities and are not investing or financing events. Therefore, if the activity that generated the cash flow does not meet the definitions of an investing or financing activity, the entity should classify the cash flow as an operating activity. Some examples of an entity's revenue producing activities might include collections from customers, payments to suppliers for goods or services, payments made to the entity's employees, and income taxes paid.

15.22 IAS 7 permits an entity to report cash flows from operating activities using either of the following presentations:

- Direct method
- Indirect method

15.23 IAS 7 encourages entities to report operating cash flows using the direct method. The direct method provides disaggregated cash flow information, not provided by the indirect method, that financial statement users may find helpful in estimating the amount, timing, and uncertainty of an entity's future cash flows.

Direct Method

15.24 When using the direct method, an entity discloses the major classes of gross cash receipts and payments. An entity may report on a net basis the following cash receipts and payments:

- On behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity
- For items with quick turnover, in large amounts, and with short maturities[1]

15.25 An entity normally obtains cash flow information from its accounting records or by adjusting sales, cost of sales, and other items in the statement of profit or loss and other comprehensive income for the following:

- Changes during the period in inventory and operating receivables and payables
- Noncash items
- Items that should be presented as investing or financing activities

15.26 Examples of cash flows from operating activities may include the following:

- Cash receipts from the following:
  - Sale of goods
  - Providing services
  - Royalties, commissions, fees, or other types of revenue, such as interest and dividends received, proceeds from the sale of loan portfolios, and so on
- Cash payments to or for the following:
  - Suppliers or vendors for goods and services
  - Employees
  - Taxes
  - Interest
  - Rent

[1] Readers may refer to paragraphs 22–24 of International Accounting Standard 7, *Statement of Cash Flows*, for additional detailed guidance relating to reporting cash flows on a net basis.

Indirect Method

15.27 When using the indirect method, the entity adjusts profit or loss, either before or after the allocation to any noncontrolling interest, for the effects of the following:

- Noncash income and expense items, such as unrealized foreign exchange effects from operating activities or depreciation and amortization expense
- Nonoperating income or expense items that resulted from investing or financing activities, such as gains or losses on the disposal of PP&E or equity in earnings of associates
- Changes in current operating assets and liabilities; that is, deferrals or accruals of past or future cash flows from operating activities

Other Presentation Matters

Foreign Currency[2]

15.28 IAS 7 requires an entity to record cash flows from transactions denominated in a foreign currency in its functional currency by applying the exchange rate that exists between that foreign currency and its functional currency on the date of the transaction. The entity translates the cash flows of a foreign subsidiary at the exchange rates between the foreign currency and its functional currency at the dates of the cash flows.

15.29 An entity should present cash flows denominated in a foreign currency in the statement of cash flows in a manner consistent with IAS 21, *The Effects of Changes in Foreign Exchange Rates*. Therefore, an entity can use an exchange rate that estimates the actual rate when recording its own foreign currency transactions or translating a foreign subsidiary's cash flows. For example, the entity may use a weighted average exchange rate for the period, but IAS 21 does not permit an entity to the use of an end of period exchange rate.

15.30 Unrealized foreign currency exchange rate gains and losses are not cash flows. However, paragraph 28 of IAS 7 states that an entity should report the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and end of the period. The entity presents this amount separately from cash flows from operating, investing, and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

Interest and Dividends

15.31 An entity discloses the amounts of interest paid, interest received, dividends paid, and dividends received separately. An entity should classify each of these cash flows consistently from period to period, in the applicable operating, investing, or financing activities section of the statement of cash flows.

15.32 An entity should disclose the total amount of interest paid during the period, regardless of whether it has been recognized as an expense in profit or loss or capitalized in accordance with IAS 23, *Borrowing Costs*.

15.33 Paragraph 33 of IAS 7 permits an entity to classify interest paid and interest and dividends received as operating cash flows because they enter into the determination of profit or loss. Alternatively, interest paid may be classified as a financing cash flow and interest and dividends received as investing cash flows because they are costs of obtaining resources or returns on investments. As expected, financial institutions usually classify interest paid and interest and dividends received as operating cash flows.

15.34 Dividends paid are a cost of obtaining financial resources and, therefore, the entity would normally classify dividend payments as financing cash flows. However, an entity may choose to classify dividends as an operating cash flow to help users understand the entity's ability to pay dividends out of its operating activities.

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[2] Refer to chapter 22, "Foreign Currency Translation," of this book for additional guidance.

Taxes on Income

15.35 Entities should report cash flows that arise from income taxes separately as an operating activity, unless the entity can specifically identify the tax receipt or payment with a financing or investing activity. An entity should disclose the total amount of taxes paid when it reports tax cash flows in more than one classification.

Investments in Subsidiaries, Associates, and Joint Ventures

15.36 An entity discloses in the cash flow statement only cash flows between itself and its investees, who may be associates, joint ventures, or subsidiaries, accounted for using the equity or cost method. These cash flows may include dividends received, advances to, and repayments from, the investee.

Change in Ownership Interest in Subsidiaries and Other Businesses

15.37 An entity sometimes will have cash flows that arise from a change in ownership interest in subsidiaries or other types of business entities. The entity presents these cash flows as separate line items in the investing activities section of the statement of cash flows. An entity does not offset cash inflows from obtaining or cash outflows from losing control over subsidiaries or other businesses; instead, these are presented separately to distinguish them from other operating, investing, and financing activities.

15.38 An entity should classify cash flows that arise from changes in ownership interests that do not result in a loss of control as cash flows from financing activities in accordance with paragraph 42A of IAS 7.

15.39 When an entity obtains or loses control of subsidiaries and other businesses, it should disclose the following information during the period:

- Total amount of consideration received or paid
- Portion of the consideration consisting of cash and cash equivalents
- Amount of cash and cash equivalents of the subsidiaries or other businesses that they lost or obtained control
- Amount of the assets and liabilities other than cash or cash equivalent in the subsidiaries or other businesses in which control is obtained or lost, summarized by each major category.

Noncash Transactions

15.40 An entity sometimes engages in transactions that do not require the use of cash or cash equivalents. Even when these transactions are significant investing and financing transactions, IAS 7 prohibits the entity from presenting these noncash transactions in the statement of cash flows. However, an entity should disclose significant noncash financing and investing activities elsewhere in the financial statements to provide financial statement users with all relevant information about these activities. Examples of noncash transactions that an entity might have are the following:

- Acquiring an asset and assuming a liability for that acquisition
- Converting a debt obligation to equity
- Acquiring an entity by issuing equity instruments

Disclosure

15.41 In accordance with IAS 1, an entity should disclose the policy used in determining the composition of cash and cash equivalents. When an entity changes this policy, it should report that change in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. An entity should also disclose any restricted amounts of cash and cash equivalents.

15.42 IAS 7 encourages that an entity also report the following additional information when it is relevant to users' understanding of the financial statements:

- Undrawn borrowing facilities available
- The aggregate cash flow amounts related to interests proportionately consolidated joint ventures
- The aggregate amount of cash flows representing increases in operating capacity
- Operating, investing, and financing cash flows by segment

Chapter 16

Business Combinations

Overview

16.01 A *business combination* is a transaction or other event in which an acquirer obtains control of one or more businesses, including transactions sometimes referred to as true mergers or mergers of equals.

16.02 The objective and core principle of the guidance described in this chapter is to improve the relevance, reliability, and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects, including what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

16.03 This chapter describes the principles and requirements for how the acquirer in a business combination recognizes, measures, and discloses in its financial statements the identifiable assets acquired, liabilities assumed, acquired goodwill or gain from a bargain purchase, and any noncontrolling interest in the acquiree.

Summary of Selective Accounting Guidance

16.04 The primary authoritative literature relating to the accounting for business combinations is International Financial Reporting Standard (IFRS) 3, *Business Combinations*.

Scope and Scope Exceptions

16.05 The scope of this chapter and IFRS 3 should apply to transactions or other events that meet the definition of a business combination.

16.06 IFRS 3 and the scope of this chapter do not apply to the following:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business
- A combination of entities or businesses under common control

16.07 When the entity acquires an asset or group of assets that do not constitute a business, it should identify and recognize the individual identifiable assets acquired, including assets that meet the definition of an identifiable intangible asset in accordance with International Accounting Standard (IAS) 38, *Intangible Assets*, and any liabilities assumed. At the date of purchase, the entity should allocate the cost of a group of assets to the individual identifiable assets and liabilities on the basis of their relative fair values. The entity does not recognize goodwill as an asset.

16.08 IFRS 3 does not apply to combinations of entities or businesses that are ultimately controlled by the same party or parties, both before and after the business combination, and this control is not transitory. Refer to paragraphs B1–B4 of appendix B, "Application Guidance," of IFRS 3 for additional discussion regarding business combinations of entities under common control.

Recognition and Measurement

16.09 IFRS 3 applies to transactions and events that meet the definition of a business combination, which requires that the assets acquired and liabilities assumed constitute a business. If this definition is not met, the reporting entity should account for the transaction or other event as an asset acquisition.

16.10 A business combination may be structured in a variety of ways for taxation, legal, and other reasons, and the acquirer may gain control of one or more business of the acquiree in a variety of ways, which including the following:

- Transferring cash, cash equivalents, or other assets, which would include net assets that constitute a business
- Incurring liabilities
- Issuing equity interests
- Providing more than one type of consideration, such as cash and incurring liabilities
- Transferring without consideration, which may include gaining control by contract alone

Refer to paragraphs B5–B12 of appendix B in IFRS 3 for application guidance on the definition of a business and the identification of a business combination.

The Acquisition Method

16.11 An entity should apply the acquisition method to account for each business combination. The application of the acquisition method requires the following:

- Identifying the acquirer
- Determining the *acquisition date*
- Recognizing and measuring the following:
  - The identifiable assets acquired
  - The liabilities assumed
  - Any noncontrolling interest in the acquiree
  - Goodwill or a gain from a bargain purchase

Identifying the Acquirer

16.12 An acquirer should be identified from one of the combining entities in each business combination. The entity that obtains control of the acquiree is identified as the acquirer in accordance with IFRS 10, *Consolidated Financial Statements*. When application of IFRS 10 does not clearly indicate which one of the combining entities is the acquirer, IFRS 3 provides other pertinent facts and circumstances that the entity should consider in making the determination. These factors are described in paragraphs B14–B18 of appendix B in IFRS 3 and include the following characteristics of an acquirer:

- The entity that transfers the cash or other assets or incurs the liabilities.
- The combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.
- The combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.
- The combining entity whose owners have the ability to elect, appoint, or remove a majority of the members of the governing body of the combined entity.
- The combining entity whose (former) management dominates the management of the combined entity.
- The combining entity that pays a premium over the precombination fair value of the equity interests of the other combining entity or entities.
- The combining entity whose relative size, measured in, for example, assets, revenues, or profit, is significantly greater than that of the other combining entity or entities.

16.13 Sometimes new entities are formed to issue equity interests to affect the business combination. These newly formed entities may not necessarily be the acquirer. When this occurs, the entity that issues securities may be identified as the legal acquirer, but not the acquirer for accounting purposes in accordance with IFRS 3. This is known as a *reverse acquisition*, described in more detail in paragraph B19 of appendix B in IFRS 3. Refer to paragraphs IE1–IE15 of the illustrative examples that accompany IFRS 3 for an example of a reverse acquisition.

Determining the Acquisition Date

16.14 The entity considers the acquisition date to be the date the acquirer obtains control of the acquiree. This date is generally the closing date or the date the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree. The acquirer should consider all pertinent facts and circumstances when identifying the acquisition date because in some cases the acquirer may obtain control earlier or later than the closing date. For example, the acquirer may gain effective control of the acquirer before the closing date by written agreement with the shareholders of the acquiree.

Recognition and Measurement Under the Acquisition Method

Recognition Principle and Conditions

16.15 The acquirer recognizes the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree separately from goodwill, as of the acquisition date.

16.16 When an entity applies the acquisition method, the identifiable assets acquired and liabilities assumed are subject to specific conditions in order to qualify for recognition. First, at the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities as defined in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*. For example, an acquirer may expect to incur costs in the future, which it is not obligated to incur, in order to exit an activity of the acquiree or to terminate the employment of or relocate employees of the acquiree after the acquisition. These costs are not recognized as liabilities at the acquisition date when applying the acquisition method because they do not meet the definition of a liability; they are not present obligations of the acquirer. Instead, the acquirer recognizes these costs in its postcombination financial statements in accordance with other IFRSs, such as IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, for activities it intends to exit.

16.17 In order to qualify for recognition under the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree, or its former owners, exchanged in the business combination transaction. If the acquirer received any of these assets or liabilities through separate transactions, then the acquirer accounts for these assets and liabilities in accordance with other applicable IFRSs.

16.18 The acquirer may recognize some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, an acquiree may have internally developed brand names, customer relationships, and patents, whose costs the acquirer expensed when incurred. When these internally generated intangible assets meet the recognition criteria in IFRS 3, the acquirer should recognize these assets as acquired identifiable intangible assets as part of the business combination.

16.19 Refer to paragraphs B28–B40 of appendix B in IFRS 3 for additional guidance on recognizing operating leases and intangible assets, including reacquired rights, assembled workforces, and other items that are not identifiable. IFRS 3 provides limited exceptions to the application of the recognition principle and conditions for specific types of identifiable assets and liabilities. These exceptions are described in paragraphs 16.27–.38.

16.20 Illustrative examples of identifiable intangible assets are described in IE16–IE44 of the illustrative examples that accompany IFRS 3. These examples include the following types of intangible assets:

- Marketing-related intangible assets, such as the following:
  - Trademarks, trade names, service marks, collective marks, and certification marks
  - Trade dress (unique color, shape, packaging design)
  - Newspaper mastheads
  - Internet domain names
  - Noncompetition agreements

- Customer-related intangible assets, such as the following:
  - Customer lists
  - Order or production backlog
  - Customer contracts and related customer relationships
  - Noncontractual customer relationships
- Artistic-related intangible assets, such as the following:
  - Plays, operas, and ballets
  - Books, magazines, newspapers, and other literary works
  - Musical works such as compositions, song lyrics, and advertising jingles
  - Pictures and photographs
  - Video and audiovisual material, including motion pictures or films, music videos, and television programs
- Contract-based intangible assets, such as the following:
  - Licensing, royalty, and standstill agreements
  - Advertising, construction, management, service, or supply contracts
  - Lease agreements, whether the acquiree is the lessee or the lessor
  - Construction permits
  - Franchise agreements
  - Operating and broadcast rights
  - Servicing contracts, such as mortgage servicing contracts
  - Employment contracts
  - Use rights, such as drilling, water, air timber cutting, and route authorities
- Technology-based intangible assets, such as the following:
  - Patented technology
  - Computer software and mask works
  - Unpatented technology
  - Databases, including title plants
  - Trade secrets, such as secret formulas, processes, and recipes

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed

16.21 An acquirer classifies or designates identifiable assets and liabilities assumed at the acquisition date. The acquirer determines classifications and designations upon its operating and accounting policies, contractual terms, economic conditions, and other pertinent conditions that existed at the date of acquisition. Subsequently, the acquirer applies the guidance in other IFRSs to the acquired identifiable assets and liabilities assumed. For example, the entity should assess property, plant, and equipment for impairment in accordance with IAS 36, *Impairment of Assets*, after the acquisition date. Some examples of the classification or designation an acquirer should make include the following:

- When the acquirer classifies financial assets and liabilities as a financial asset or liability at fair value through profit or loss, or as a financial asset available for sale or held to maturity, in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*[1]
- When the acquirer designates a derivative instrument as a hedging instrument in accordance with IAS 39[2]

[1] References to International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, replace all references to International Auditing Standard 39, *Financial Instruments: Recognition and Measurement*, upon adoption of IFRS 9 or its effective date, which is for annual periods on or after January 1, 2015.

[2] See footnote 1.

- When the acquirer should assess whether it should separate an embedded derivative from a host contract in accordance with IAS 39[3]

16.22 IFRS 3 provides the following two classification exceptions for certain contracts:

- Classifying a lease contract as either an operating lease or a finance lease should be in accordance with IAS 17, *Leases*.
- Classifying a contract as an insurance contract should be in accordance with IFRS 4, *Insurance Contracts*.

16.23 The acquirer should classify these contracts based upon their contractual terms and other factors either at the inception of the contract or if the terms of the contract have been modified in a way that would change their classification at the date of that modification, which may be the acquisition date.

Measurement Principle

16.24 An acquirer measures identifiable assets acquired and liabilities assumed at fair value at their acquisition date.

16.25 For each business combination, an acquirer measures any noncontrolling interest either at its fair value or at the noncontrolling interest's proportional share of the identifiable net assets of the acquiree. Refer to paragraphs B41–B45 of appendix B in IFRS 3 for application guidance on measuring the fair value of particular identifiable assets and liabilities, which include the following:

- Assets with uncertain cash flows and recognition of a valuation allowance
- Assets subject to operating leases in which the acquiree is the lessor
- Assets that the acquirer does not intend to use, such as an acquired brand name, or to use in a way that is different from the way other market participants would use these assets, such as may be the case with the research and development of an intangible asset
- Noncontrolling interest in an acquiree

16.26 IFRS 3 provides limited exceptions to the application of the measurement principle for specific types of identifiable assets and liabilities. These exceptions are described in paragraphs 16.27–.38.

Exceptions to the Recognition or Measurement Principles

16.27 IFRS 3 provides limited exceptions to its recognition and measurement principles. The nature of those exceptions and how an acquirer should account for those items will usually result in the acquirer applying the requirements of other IFRSs in addition to those of IFRS 3. Guidance in other IFRSs may result in the acquirer applying different recognition principles and conditions and measuring items at amounts other than fair value at the acquisition date.

Contingent Liabilities

16.28 There is an exception to the measurement principle in IFRS 3 for certain contingent liabilities. An acquirer should recognize a contingent liability, as defined in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, as of the acquisition date, even if it is not probable that settlement of the obligation will result in an outflow of resources representing economic benefits, if the following criteria are met:

- The present obligation arises from past events.
- Its fair value can be measured reliably.

16.29 Paragraphs 16.80–.81 provide guidance on the subsequent accounting for the contingent liabilities assumed. Refer to chapter 28, "Provisions, Contingent Liabilities, and Contingent Assets," of this book for additional discussion regarding contingent liabilities.

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[3] See footnote 1.

Income Taxes

16.30 An acquirer should account for the potential tax effects of temporary differences and tax loss carryforwards of an acquiree that existed at the acquisition date or may have occurred as a result of the acquisition in accordance IAS 12. Therefore, an acquirer should recognize and measure deferred tax assets or liabilities arising from acquired assets or liabilities assumed in a business combination in accordance with IAS 12, *Income Taxes*. Refer to chapter 10, "Income Taxes," of this book for additional guidance on deferred tax assets or liabilities.

Employee Benefits

16.31 An acquirer should recognize and measure a liability or an asset related to an acquiree's employee benefit arrangement in accordance with IAS 19, *Employee Benefits*. Refer to chapter 34, "Employee Benefits," of this book for guidance on accounting for employee benefits.

Indemnification Assets

16.32 The acquirer in a business combination may receive contractual indemnification from the seller for the outcome of a contingency or uncertainty related to part or all of a specific asset or liability. For example, the seller may guarantee that a particular liability would not exceed a specific amount, indemnifying the acquirer against losses above a that amount that arise from that liability. As a result, the seller gave the acquirer an indemnification asset.

16.33 The acquirer recognizes and measures an indemnification asset and the indemnified item at the same time and on the same basis, subject to the need for a valuation allowance. If the indemnified item is related to an asset or a liability recognized and measured at fair value at the acquisition date, then the acquirer should recognize the indemnification asset at the acquisition date at its fair value on that date. The acquirer includes the effects of uncertainty about future cash flows relating to collectability considerations into the fair value measurement. Therefore, the acquirer does not need a separate valuation allowance. Refer to paragraph B41 of appendix B in IFRS 3 for guidance about the consideration of the uncertainty of future cash flows.

16.34 In some circumstances, a seller may provide an indemnification that relates to an asset or liability that is an exception to IFRS 3 recognition or measurement principles. For example

- the seller provides an indemnification to the acquirer for a contingent liability, but that liability's fair value at the date of acquisition cannot be measured reliably.
- the seller may provide an indemnification that relates to an asset or a liability, such as in the case of an employee benefit, which is measured on a basis other than its acquisition date fair value, in accordance with IAS 19.

16.35 Under these circumstances, the acquirer should recognize and measure the indemnification asset using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount. The subsequent accounting for the indemnification asset is discussed in paragraph 16.82.

Reacquired Rights

16.36 Reacquired rights are another exception to the measurement principle of IFRS 3. When an acquirer reacquires rights, it should measure an intangible asset measured on the basis of the remaining contractual term of the related contract, regardless of whether market participants would consider potential contractual renewals in determining its fair value. Refer to paragraphs B35–B36 of appendix B in IFRS 3 for related application guidance.

Share-Based Payment Awards

16.37 An acquirer does not measure the replacement of an acquiree's share-based payment awards with share-based payment awards from the acquirer in accordance with IFRS 3. The acquirer should measure the related liability or equity instrument associated with the share-based payment award in accordance with the method in IFRS 2, *Share-based Payment*.

Assets Held for Sale

16.38 An acquirer measures noncurrent assets or a disposal group that it classifies as held for sale at fair value at the acquisition date, less the costs to sell, in accordance with paragraphs 15–18 of IFRS 5.

Recognizing and Measuring Goodwill or a Gain From a Bargain Purchase

16.39 At the acquisition date, goodwill is measured by the acquirer as

a. the aggregate of

i. consideration transferred, which is generally required to be measured at the acquisition date fair value, in accordance with IFRS 3;

ii. amount of any noncontrolling interest in the acquiree, measured in accordance with IFRS 3; and

iii. for a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b. less

i. net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with IFRS 3.

16.40 When the acquirer and the acquiree, or its former owners, exchange only equity interests, the fair value of the acquiree's equity interest at the acquisition date may be a more reliable measurement than the acquisition date fair value of the equity interests of the acquirer. Under these circumstances, the acquirer measures the amount of goodwill using the calculation above substituting the fair value of the acquiree's equity interest at the acquisition date for the acquisition-date fair value of the equity interests transferred by the acquirer.

16.41 When no consideration is transferred, the acquirer measures the amount of goodwill using a valuation technique to measure the acquisition date fair value of the acquirer's interest in the acquiree.

16.42 Refer to paragraphs B46–B49 of appendix B in IFRS 3 for application guidance for measuring the acquisition date fair value of the acquirer's interest in the acquiree using valuation techniques, and special considerations when applying the acquisition method to combinations of mutual entities. A *mutual entity* is defined as an entity, other than investor-owned, that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants, such as in the case of credit unions, mutual insurance companies, and cooperative entities.

Bargain Purchases

16.43 Occasionally, an acquirer will acquire a business in a bargain purchase. A bargain purchase occurs in a business combination when the net amount of the identifiable assets acquired and the liabilities assumed by the acquirer at the acquisition-date, as described in paragraph 16.39*b*, exceeds the aggregate of the consideration transferred which might include the amount of any noncontrolling interest in the acquiree, as described in paragraph 16.39*a*.

16.44 The excess, if any, may result in the acquirer recognizing a gain in profit or loss on the acquisition date, after the application of the requirements described in paragraph 16.46.

16.45 A bargain purchase might occur when a seller is forced to sell due to financial pressures, pending litigation, or regulatory requirements. Additionally, sometimes applying the recognition or measurement exceptions for particular items described in paragraphs 16.27–.38 may result in either recognition of a gain or a change in the amount of the recognized gain on a bargain purchase.

16.46 An acquirer should reassess any gain on a bargain purchase to determine whether all the assets acquired and all the liabilities assumed have been correctly identified and if it should recognize any additional assets or liabilities as a consequence of that review. The acquirer should review the procedures used to measure the amounts recognized at the acquisition date for all of the following items to ensure that the measurements appropriately reflect all available information as of the acquisition date:

- Identifiable assets acquired and liabilities assumed
- Noncontrolling interest in the acquiree, if any
- For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree
- Consideration transferred

16.47 The following example illustrates the accounting for a business combination in which an acquirer recognized a gain on a bargain purchase, as described in IE45–IE49 of the illustrative examples that accompany IFRS 3.

On January 1, 2012, CD acquires 80 percent of the equity interests of AB, a private entity, in exchange for cash of CU150. Because the former owners of AB needed to dispose of their investments in AB by a specified date, they did not have sufficient time to market AB to multiple potential buyers. The management of CD initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of IFRS 3. The identifiable assets are measured at CU250 and the liabilities assumed are measured at CU50. CD engages an independent consultant, who determines that the fair value of the 20 percent noncontrolling interest in AB is CU42.

The amount of AB's identifiable net assets (CU200, calculated as CU250 – CU50) exceeds the fair value of the consideration transferred plus the fair value of the noncontrolling interest in AB. Therefore, CD reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the noncontrolling interest in AB and the consideration transferred. After that review, CD decides that the procedures and resulting measures were appropriate. CD measures the gain on its purchase of the 80 percent interest as follows:

	Fair value of the identifiable assets acquired		CU 250
Less:	Fair value of the liabilities assumed		(CU 50)
	Fair value of the identifiable net asset acquired		CU 200
Less:	80 percent interest in AB; plus	CU 150	
	Fair value of noncontrolling interest in AB	CU 42	
			CU 192
	Gain on bargain purchase of 80 percent interest		CU 8

CD records the acquisition of AB in its consolidated financial statements as follows:

Dr	Identifiable asset acquired		CU 250	
	Cr	Liabilities assumed		CU 50
	Cr	Cash		CU 150
	Cr	Equity—Noncontrolling interest		CU 42
	Cr	Gain		CU 8

If the acquirer chose to measure the noncontrolling interest in AB on the basis of its proportionate interest in the identifiable net assets of the acquiree, the recognized amount of the noncontrolling interest would be CU40 (CU200 × 0.20). The gain on the bargain purchase then would be CU10 (CU200 - (CU150 + CU40)):

	Fair value of the identifiable assets acquired		CU 250
Less:	Fair value of the liabilities assumed		(CU 50)
	Fair value of the identifiable net asset acquired		CU 200
Less:	80 percent interest in AB; plus	CU 150	

Proportionate share of net identifiable assets acquired	CU 40	
		CU 190
Gain on bargain purchase of 80 percent interest		CU 10

Consideration Transferred

16.48 The acquirer measures the consideration transferred at fair value as the sum of the following amounts:

- Acquisition-date fair values of the assets transferred by the acquirer
- Liabilities incurred by the acquirer to former owners of the acquiree
- Equity interests issued by the acquirer

16.49 However, the acquirer measures any share-based payment awards it issued in exchange for awards held by the acquiree's employees that are included in consideration transferred in accordance with IFRS 2, resulting in a market-based measure of the award, rather than fair value.

16.50 Examples of forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants, and member interests of mutual entities.

16.51 The carrying amounts of the consideration transferred by the acquirer may differ from their fair value at the acquisition date; for example, transfer of nonmonetary assets (property, plant, and equipment or equity investments in other entities) or a business or a subsidiary of the acquirer. At the acquisition date, the acquirer should remeasure the transferred assets or liabilities to their fair value and recognize a gain or loss, if any, in profit or loss. If the transferred assets or liabilities remain within the combined entity of the acquirer after the business combination, the acquirer should measure those assets and liabilities at their carrying amounts immediately before the acquisition date and not recognize a gain or loss in profit or loss because it controlled the assets or liabilities both before and after the business combination.

Contingent Consideration

16.52 Contingent consideration is usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquiree if specified future events occur or conditions are met. Additionally, contingent consideration may also give the acquirer the right to have previously transferred consideration returned if specified future events do not occur or conditions are met.

16.53 The consideration the acquirer transferred in exchange for the acquiree may include a contingent consideration arrangement. The acquirer should recognize any contingent consideration as part of the consideration transferred at its acquisition-date fair value.

16.54 An acquirer should recognize an obligation to pay contingent consideration as either a liability or equity based on the definitions of liabilities and equity, respectively, in paragraph 11 of IAS 32, *Financial Instruments: Presentation*, or other applicable IFRSs (IAS 39 or IFRS 9, *Financial Instruments*, as appropriate). An acquirer should recognize the right of the return of previously transferred consideration, providing specified conditions as an asset.

16.55 The subsequent accounting for contingent consideration is described in paragraphs 16.83–.85.

Applying the Acquisition Method to Particular Types of Business Combinations

Achieving a Business Combination in Stages

16.56 An acquirer may achieve a business combination in stages. Sometimes the acquirer will hold an equity interest in an acquiree immediately before obtaining control on the acquisition date. When a business combination is achieved in stages, it is commonly referred to as a step acquisition.

16.57 When a business combination is achieved in stages, the acquirer remeasures the previously held equity interest of the acquiree at its acquisition-date fair value and recognizes a gain or loss, if any, in the profit or loss or other comprehensive income, as appropriate. If the acquirer had previously recognized changes in the value of the equity interest in the acquiree in other comprehensive income, the acquirer should account for the amount recognized in other comprehensive income on the same basis as it would have accounted for that amount if it had disposed previously held equity interest directly.

16.58 The following is an example of a step acquisition for a manufacturer.

Example 16-1: Step Acquisition

Facts

On October 10, 2010, a manufacturer purchases a 25 percent noncontrolling interest in an entity (Entity A). On November 14, 2010, the manufacturer purchases another 5 percent noncontrolling interest in Entity A.

Step Acquisition

On December 31, 2010, the manufacturer holds a 30 percent noncontrolling interest in Entity A. On the same day, the manufacturer purchases an additional 40 percent of Entity A and holds a controlling interest in Entity A, having achieved the business combination in stages.

Achieving a Business Combination Without Transfer of Consideration

16.59 Sometimes an acquirer can achieve a business combination (control) without transfer of consideration. An acquirer should apply the acquisition method when accounting for these business combinations. Circumstances in which an acquirer may obtain control of an acquiree with transferring consideration include the following:

- The acquiree repurchases a sufficient number of its own shares so that an existing investor has more than 50 percent of the acquiree's outstanding shares; therefore, the investor has de facto control, and becomes the acquirer.
- An investor holds the majority voting rights of an entity and the minority's veto rights that prevented the investor from controlling an acquiree lapse; therefore, the majority shareholder has control and becomes the acquirer.
- Acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual-listed corporation.

16.60 When a business combination is achieved by contract alone, any equity interests in the acquiree held by parties other than the acquirer are noncontrolling interests in the acquirer's postcombination financial statements, even if all the equity interests in the acquiree are attributed to the noncontrolling interest.

Measurement Period

16.61 If the initial accounting for a business combination is incomplete by the end of the reporting period in which a business combination occurs, an acquirer should report in its financial statements provisional amounts for items for which the accounting is incomplete. The acquirer retrospectively adjusts provisional amounts recognized at the acquisition date during the measurement period of the business combination. The acquirer makes these retrospective adjustments to provisional amounts to reflect new information obtained about the facts and circumstances that existed at the acquisition date and, if known, would have affected the measurement of the recognized amounts at that date.

16.62 When it obtains new information during the measurement period about facts and circumstances that existed at the acquisition date, an acquirer may recognize additional assets or liabilities because, if it had known the information at that date, the acquirer would have recognized those assets and liabilities or measured them at a different amount.

16.63 The measurement period is the period after the acquisition date during which the acquirer may adjust provisional amounts recognized for a business combination. It provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following:

- Identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree
- Consideration transferred for the acquiree, or the other amount used in measuring goodwill
- In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer
- Any goodwill or gain on a bargain purchase

16.64 The measurement period for a business combination should not exceed more than one year from the acquisition date and ends as soon as the acquirer either receives the information it sought about facts and circumstances that existed at the acquisition date, or learns that more information is not obtainable.

16.65 All pertinent factors are considered by the acquirer when determining whether the new information it obtained after the acquisition date

a. existed at the acquisition date should be used to adjust a recognized provisional amount, or

b. resulted from events that occurred after the acquisition date and should not be used to adjust a recognized provisional amount.

16.66 The date when additional information is obtained and whether the acquirer can identify a reason to adjust provisional amounts are considered pertinent factors to the decision to use the new information or not. Information obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than information obtained several months later. For example, the sale of an acquired asset to a third party shortly after the acquisition date for an amount that differs significantly from the provisional fair value recognized at the acquisition date is likely to indicate that the provisional amount is in error, unless the acquirer can identify an event that happened after the acquisition date is responsible for the change in fair value.

16.67 An acquirer should adjust goodwill for the following adjustments to provisional amounts:

- An increase or decrease in a provisional amount recognized for an identifiable asset or liability
- Recognition of additional assets or liabilities based upon new information obtained during the measurement period about facts and circumstances that existed at the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities

16.68 New information obtained during the measurement period sometimes results in more than one adjustment to provisional amounts of assets or liabilities. For example, an acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, of which part or all of the liability is covered by the acquiree's liability insurance policy. If new information is obtained by the acquirer during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability would result in an offset, in whole or in part, by the corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

16.69 The acquirer recognizes adjustments to provisional amounts during the measurement period as if it had completed the accounting for the business combination at the acquisition date. The acquirer should revise comparative information for prior periods presented in financial statements, as needed, including any changes in depreciation, amortization or other income effects recognized in completing the initial accounting.

16.70 An acquirer should only revise the accounting for a business combination after the measurement period ends to correct an error in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

16.71 The following example illustrates the measurement period for a business combination as described in IE 51–IE52 of the illustrative examples that accompany IFRS 3.

> Assume that CD acquires AB on September 30, 2011. CD seeks an independent valuation for an item of property, plant, and equipment acquired in the combination, but does not receive a complete valuation by the time CD authorized its financial statements for issue for the year ended December 31, 2011. Therefore, CD recognized a provisional fair value for the asset of CU 30,000 in its 2011 financial statements. At the acquisition date, the item of property, plant, and equipment had a remaining useful life of 5 years. Five months after the acquisition date, CD received the independent valuation, which estimated the asset's acquisition-date fair value as CU 40,000.
>
> In its financial statements for the year ended December 31, 2012, CD retrospectively adjusts the 2011 prior year information as follows:
>
>> CD increased the carrying amount of property, plant, and equipment as of December 31, 2011, by CU 9,500. This adjustment is the fair value measurement at the acquisition date of CU 10,000 less the additional depreciation that would have been recognized on December 31, 2011, if CD has recognized a fair value of CU 40,000 at the acquisition date (CU 500 for 3 months' depreciation).
>>
>> CD also decreases the carrying amount of goodwill as of December 31, 2011, by CU 10,000. Depreciation expense for 2011 is increased by CU 500.

Determining What Is Part of the Business Combination Transaction

16.72 The acquirer and the acquiree may have a pre-existing relationship or other arrangement before they entered into negotiations for the business combination. Additionally, they may also enter into separate arrangements apart from the business combination during the business combination negotiations. Irrespective of the situation, any amounts that are not part of what the acquirer and the acquiree, or its former owners, exchanged in the business combination should be identified. The acquirer should only recognize as part of applying the acquisition method the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree in the business combination and should account for the separate transactions in accordance with the relevant IFRSs.

16.73 Transactions entered into before the combination by or on behalf of the acquirer or that are for the primary benefit of the acquirer or the combined entity, rather than for the benefit of the acquiree or its former owners, are likely to be considered separate transactions and not part of the business combination. For example, the acquirer should not include the following transactions as part of the business combination when applying the acquisition method:

- Transactions that, in effect, settle pre-existing relationships between the acquirer and acquiree
- Transactions that remunerate employees or former owners of the acquiree for future services
- Transactions that reimburse the acquiree or its former owners for paying the acquirer's acquisition-related costs

Refer to paragraphs B50–B62 of appendix B in IFRS 3 for application guidance for determining what transactions are part of a business combination.

Acquisition-Related Costs

16.74 An acquirer should consider the costs it incurs to affect a business combination to be acquisition-related costs. These costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, which may include the costs of maintaining an internal acquisitions department; and the costs of registering and issuing debt and equity securities.

16.75 An acquirer accounts for acquisition-related costs as expenses in the periods in which they are incurred and the services are received. An exception exists regarding the costs to issue debt or equity securities. These costs should be recognized in accordance with IAS 32 and IAS 39. Refer to chapter 17, "Financial Instruments," of this book for additional guidance regarding IAS 32 and IAS 39.

Subsequent Measurement

16.76 Generally, the subsequent measurement of assets acquired, liabilities assumed or incurred, and the equity instruments issued in a business combination are accounted for by the acquirer in accordance with other applicable IFRSs, depending upon the nature of the items.

16.77 IFRS 3 provides specific guidance on the accounting and subsequent measurement for the following assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination:

- Reacquired rights
- Contingent liabilities recognized as of the acquisition date
- Indemnification assets
- Contingent consideration

16.78 Paragraph B63 of appendix B in IFRS 3 provides related application guidance on the subsequent measurement and accounting of other applicable IFRSs such as IAS 12, IFRS 10, IAS 36, IAS 38, IFRS 2, and IFRS 4.

Reacquired Rights

16.79 An acquirer recognizes reacquired rights as an intangible asset and amortizes the intangible asset over the remaining contract period in which the right was granted. The acquirer includes the carrying amount of the intangible asset when determining the gain or loss on a subsequent sale of the reacquired right to a third party.

Contingent Liabilities

16.80 Until a contingent liability recognized in a business combination settles, is cancelled, or expires, the acquirer should measure the asset at the higher of the following amounts:

- The amount that the acquire would recognize in accordance with IAS 37
- The amount recognized initially less, if appropriate, any cumulative amortization recognized in accordance with IAS 18, *Revenue*

16.81 An acquirer does not apply this requirement for contracts accounted for in accordance with IAS 39.

Indemnification Assets

16.82 At the end of each subsequent reporting period, an acquirer uses the same basis for an indemnification asset recognized at the acquisition date as it used for the indemnified liability or asset, subject to any contractual limitations on its amount. When an indemnification asset is not subsequently measured at fair value, the acquirer's management should assess the asset's collectibility. The acquirer should derecognize an indemnification asset only when it collects the asset, sells it, or otherwise loses the right to it.

Contingent Consideration

16.83 Changes in the fair value of contingent consideration recognized after the acquisition date can result from the following information:

- Events, facts, and circumstances that existed at the acquisition date but were unknown to the acquirer until after that date
- Events, facts, and circumstances that occur after the acquisition date

16.84 The former information results in adjustments to amounts recognized as part of the business combination and an acquirer should account for those changes as measurement period adjustments, as described in paragraphs 16.61–.69. The latter changes to contingent consideration result from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or the achievement of a milestone on a research and development project, and are not measurement period adjustments.

16.85 An acquirer should account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- An acquirer should not remeasure contingent consideration classified as equity and should account for its subsequent settlement within equity.
- An acquirer should account for contingent consideration classified as an asset or a liability that is
  - — a financial instrument within the scope of IAS 39, which is at fair value, with any resulting gain or loss recognized either in profit or loss or in other comprehensive income in accordance with IAS 39, as applicable; and
  - — a financial instrument not within the scope of IAS 39, in accordance with IAS 37 or other IFRSs, as appropriate.

Disclosure

16.86 An acquirer should disclose information that enables users of an acquirer's financial statements to evaluate the nature and financial effect of a business combination. The acquirer should disclose information about the nature and financial effect of a business combination that occurs either

a. during the current reporting period; or

b. after the end of the reporting period but before the financial statements are authorized for issue.

16.87 For each business combination that occurs during the reporting period, the acquirer should disclose the following information:

a. The name and a description of the acquiree.

b. The acquisition date.

c. The percentage of voting equity interests acquired.

d. A description of how the acquirer obtained control of the acquiree and the primary reasons for the business combination.

e. Qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

f. The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as

i. cash;

ii. other tangible or intangible assets, including a business or subsidiary of the acquirer;

iii. liabilities incurred (for example, a liability for contingent consideration); and

  iv. equity interests of the acquirer, including the number of instruments or interests issued or issuable, and the method of determining the fair value of those instruments or interests.

g. For contingent consideration arrangements and indemnification assets

  i. the amount recognized as of the acquisition date;

  ii. a description of the arrangement and the basis for determining the amount of the payment; and

  iii. an estimate of the range of undiscounted outcomes or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer should disclose that fact.

h. For acquired receivables

  i. the fair value of the receivables;

  ii. the gross contractual amounts receivable; and

  iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures should be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.

i. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed.

j. For each contingent liability recognized even if it is not probable that an outflow of resources embodying economic benefits will be required to settled the obligation, the information required in paragraph 85 of IAS 37 should be disclosed. If a contingent liability is not recognized because its fair value cannot be measured reliably, the acquirer should disclose

  i. the information required by paragraph 86 of IAS 37; and

  ii. the reasons why the liability cannot be measured reliably.

k. The total amount of goodwill that is expected to be deductible for tax purposes.

l. For transactions that are recognized separately from the acquisition of assets and assumption of liabilities in the business combination in which the acquirer and the acquiree may have a pre-existing relationship or other arrangements before negotiations for the business combination began, or they may have entered into an arrangement during the negotiations that is separate from the business combination, the following should be disclosed:

  i. A description of each transaction.

  ii. How the acquirer accounted for each transaction.

  iii. The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized.

  iv. If the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount.

m. The disclosure of separately recognized transactions required and described in (*l*) should include the amount of acquisition-related costs and, separately, the amount of those costs recognized as an expense and the line item or items in the statement of profit or loss and other comprehensive income in which those expenses are recognized. The amount of any issue costs not recognized as an expense and how they were recognized should also be disclosed.

n. For a bargain purchase

  i. the amount of any gain recognized from the bargain purchase and the line item in the statement of comprehensive income in which the gain is recognized; and

  ii. a description of the reasons why the transaction resulted in a gain.

o. For each business combination in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date

i. the amount of the noncontrolling interest in the acquiree recognized at the acquisition date and the measurement basis for that amount; and

ii. for each noncontrolling interest in an acquiree measured at fair value, the valuation techniques and key model inputs used for determining that value.

p. In a business combination achieved in stages, sometimes referred to as a step-purchase

i. the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

ii. the amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination and the line item in the statement of comprehensive income in which that gain or loss is recognized.

q. The following other information

i. The amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period.

ii. The revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

16.88 If disclosure of any of the required information is impracticable, as defined in IAS 8, the acquirer should disclose that fact and explain why the disclosure is impracticable.

16.89 An acquirer should disclose, in the aggregate, information regarding individually immaterial business combinations occurring during the reporting period that are collectively material. The required aggregate information is described in paragraph 16.87*e–q*.

16.90 When the acquisition date of a business combination is after the end of the reporting period but before the financial statements are authorized for issue, the acquirer should disclose the required information described in paragraph 16.87. If the initial accounting for the business combination is incomplete at the time the financial statements are authorized for issue, the acquirer should describe which of the required disclosures in paragraph 16.87 could not be made and the reasons why they cannot be made.

16.91 The acquirer should disclose information for each material business combination, or in the aggregate for individually immaterial business combinations that are material collectively, that enable users of the financial statements with the ability to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods should be disclosed. To meet this objective, the acquirer should disclose the following:

- When the initial accounting for a business combination is incomplete, the acquirer may have only provisionally determined particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination. When this occurs, the acquirer should disclose the following:
  - — The reasons why the initial accounting for the business combination is incomplete.
  - — The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete.
  - — The nature and amount of any measurement period adjustments recognized during the reporting period. Comparative information should be revised for prior periods presented in the financial statements as needed, including changes to depreciation, amortization, or other income effects recognized in completing the initial accounting.
- For each reporting period after the acquisition date and until the acquirer collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity

settles a contingent consideration liability or the liability is cancelled or expires, the acquirer should disclose the following:

  - Any changes in the recognized amounts, including any differences arising upon settlement.
  - Any changes in the range of undiscounted outcomes and the reasons for those changes.
  - The valuation techniques and key model inputs used to measure the contingent consideration.

- For contingent liabilities recognized in a business combination, the acquirer should disclose information required for each class of provision in accordance with paragraphs 84–85 of IAS 37. For a detailed discussion regarding the accounting prescribed in IAS 37, refer to chapter 28 of this book.
- A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing the following separately:
  - At the beginning of the reporting period, the gross amount and accumulated impairment losses.
  - Additional goodwill recognized during the reporting period, except for goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with IFRS 5.
  - Adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period in which the acquisition date was before IFRS 3 applied, which means that the acquirer should not adjust the accounting for prior business combinations for previously recognized changes in recognized deferred tax assets, but, from the date IFRS 3 is applied, the acquirer should recognize, as an adjustment to profit or loss, unless the adjustment is outside of profit or loss, changes in recognized deferred tax assets.
  - Goodwill included in a disposal group classified as held for sale in accordance with IFRS 5 and goodwill derecognized during the reporting period without having previously been included in a disposal group classified as held for sale.
  - Impairment losses recognized during the reporting period in accordance with IAS 36.(In addition to this disclosure requirement, IAS 36 requires disclosure of information about the recoverable amount and impairment of goodwill. Refer to chapter 6, "Impairment of Assets," of this book for additional guidance regarding impairments.)
  - Net exchange rate differences that arise during the reporting period in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*.
  - Any other changes in the carrying amount during the reporting period.
  - The gross amount and accumulated impairment losses at the end of the reporting period.
- In the current reporting period an acquirer should disclose the amount and an explanation of any gain or loss recognized that relates to the identifiable assets acquired or liabilities assumed in a business combination that was affected in the current or previous reporting period and is of such a size, nature, or incidence that disclosure is relevant to understanding the combined entity's financial statements.

16.92 An acquirer should disclose whatever additional information is necessary to meet the specific disclosure objectives in IFRS 3 and other IFRSs.

16.93 Refer to paragraph IE72 in the illustrative examples that accompany IFRS 3 for an example of some of these disclosure requirements.

Chapter 17

Financial Instruments

Overview

17.01 International Accounting Standards (IAS) 32, *Financial Instruments: Presentation*, defines a *financial instrument* as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another. A *financial asset* is any asset that is one of, or a combination of, the following:

- Cash
- An equity instrument of another entity
- A contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under potentially favorable conditions
- A contract that will or may be settled in the entity's own equity instruments and is either of the following:
  - A nonderivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

17.02 A *financial liability* is any liability that is one of, or a combination of, the following:

- A contractual obligation to deliver cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under potentially unfavorable conditions
- A contract that will or may be settled in the entity's own equity instruments and is either of the following:
  - A nonderivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

17.03 An *equity instrument* is any contract that shows a residual interest in the assets of an entity after deducting all of its liabilities. An exception to the definition of a financial liability in paragraph 17.02 is an equity instrument that has all of the features of an equity instrument and meets the conditions in IAS 32 for certain puttable instruments and instruments that impose an obligation to deliver a pro rata share of the net assets of an entity only on liquidation.

17.04 International Financial Reporting Standards (IFRSs) for financial instruments contain additional definitions that are critical for determining how an entity should apply the requirements of IFRSs for financial instruments to a particular instrument, transaction, or circumstance. These definitions are dispersed among different standards and interpretations. In addition to the definitions shown previously, both IAS 32 and IAS 39, *Financial Instruments: Recognition and Measurement*, include definitions of *fair value* and *puttable instrument*. IAS 39 also defines the following terms: *amortized cost for a financial asset or financial liability*; *effective interest method*; *derecognition*; *derivative*; *financial guarantee contract*; *regular way purchase or sale*; *transaction costs*; and, in the context of hedge accounting, *firm commitment*; *forecast transaction*; *hedged item*; and *hedging effectiveness*.

17.05 In addition to the defined terms previously mentioned, IAS 39 also defines the following four categories that an entity should use to classify financial assets for the purpose of measuring the asset after initial recognition:

- At fair value through profit or loss (FVTPL), which includes financial assets and financial liabilities classified as either
  - held for trading; or
  - designated on initial recognition (designated at FVTPL).
- Held to maturity (HTM)
- Loans and receivables
- Available-for-sale financial assets (AFS)

Summary of Selective Accounting Guidance

17.06 The primary accounting literature that relates to accounting for financial instruments are the following:

- IAS 32, which establishes the principles for distinguishing a financial liability from an equity instrument and for offsetting financial assets and liabilities on the statement of financial position.
- IAS 39, which establishes the principles for recognizing and measuring financial assets and financial liabilities as well as for some contracts to buy or sell nonfinancial items. IAS 39 also establishes the principles under which an entity would have an effective hedging relationship and be able to apply hedge accounting.
- IFRS 7, *Financial Instruments: Disclosures*, which establishes the disclosures that an entity should provide about the significance of financial instruments to their balance sheet and statement of profit or loss and other comprehensive income and the risks from these instruments to which it is exposed.
- IFRS 9, *Financial Instruments*, which addresses initial recognition and derecognition, classification of financial assets, measurement, and hedge accounting, and replaces the requirements of IAS 39 for financial assets and financial liabilities within its scope. IFRS 9 is effective for annual periods on or after January 1, 2015. Adopting the guidance early is permitted.

Author's Note: In November 2009, the International Accounting Standards Board (IASB) issued IFRS 9 as the first stage in its project to replace IAS 39. IFRS 9 covers classification and measurement of financial assets. The chapters in IFRS 9 that relate to classification and measurement of financial assets require the following:

- An entity should classify financial assets on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.
- An entity should initially measure the financial asset at fair value, plus, in the case of a financial asset not classified at FVTPL, particular transaction costs.
- Subsequently, an entity measures the financial asset at fair value or amortized cost.

In October 2010, the IASB issued a revised IFRS 9 carrying over most of the requirements in IAS 39 for classification and measurement of financial liabilities, with the following exceptions:

- The exception from fair value measurement was eliminated for derivative liabilities that are linked to and must be settled by deliver of an equity instrument that does not have a quoted price in an active market for an identical instrument. Therefore, an entity measures such instruments at fair value, not at cost.
- The requirements related to the fair value option were changed to address own credit risk. An entity should recognize the amount of a change in fair value of a financial liability that is attributable to changes in the credit risk of that liability (its "own credit risk") in other comprehensive income; it should only recognize the remaining amount of the change in fair value in profit or loss.

Along with these changes, the reissued IFRS 9 contained a revised basis for conclusion and withdrew International Financial Reporting Interpretations Committee (IFRIC) 9, *Reassessment of Embedded Derivatives*, and the 2009 version of IFRS 9.

Refer to chapter 8, "Effective Date and Transition," of IFRS 9 for further discussion of the effective date and transition considerations.

17.07 IFRS 4, *Insurance Contracts*, addresses accounting and disclosure for financial instruments embedded in insurance contracts, which are outside the scope of IAS 32 and IAS 39.

17.08 In addition, the IASB issued the following interpretations that are applicable to the financial instruments covered by the previous standards:

- IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments*
- IFRIC 9
- IFRIC 19, *Extinguishing Financial Liabilities with Equity Instruments*

Scope

17.09 IAS 32 applies to all financial instruments, except the following:

- Interests in subsidiaries, associates, or joint ventures accounted for in accordance with IAS 27, *Consolidated and Separate Financial Statements*; IAS 28, *Investments in Associates and Joint Ventures*; and IFRS 10, *Consolidated Financial Statements*, respectively, unless the entity is permitted to account for these investments in accordance with IAS 39. In such cases, an entity should apply the requirements of IAS 32.
- Employers' rights and obligations under employee benefit plans, accounted for in accordance with IAS 19, *Employee Benefits*.
- Insurance contracts within the scope of IFRS 4 (except when IAS 32 specifically provides otherwise, including financial instruments within the scope of IFRS 4 because they contain a discretionary participation feature).
- Financial instruments, contracts, and obligations accounted for in accordance with IFRS 2, *Share-based Payment* (except for certain contracts within the scope of paragraphs 8–10 and treasury stock within the scope of paragraphs 33–34 of IAS 32).

17.10 However, an entity should apply the requirements of IAS 32 to contracts to buy or sell a nonfinancial item that the entity can settle net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts themselves were financial instruments.

17.11 IAS 39 establishes the recognition and measurement requirements for financial instruments. In addition to those items excluded from the scope of IAS 32, the scope of IAS 39 excludes the following:

- Rights and obligations accounted for in accordance with IAS 17, *Leases*, except for certain lease receivables, finance lease payables, and embedded derivatives
- Forward contracts to buy or sell an acquiree that will result in a business combination
- Certain loan commitments
- Reimbursement rights for previously recognized provisions

17.12 However, the scope of IAS 39 includes the following loan commitments:

- Designated at FVTPL
- That an entity can settle net in cash and by delivery or exchange of financial instruments (settled net
- To provide a loan at a below-market rate

17.13 An entity should apply IAS 39 to contracts to buy or sell a nonfinancial item that can be settled net, except when the entity enters into and continues to hold such contracts for receipt or delivery as part of its normal expected sale, purchase, or usage requirements.

17.14 IFRS 7 applies to all financial instruments that are not excluded from the scope of IAS 32, except instruments required to be classified as equity instruments in accordance with paragraphs 16(A)–16(D) of IAS 32. The standard also applies to share-based payment contracts that are within the scope of IAS 39, rather than IFRS 2.

Recognition and Measurement

17.15 IAS 39 requires an entity to recognize a financial asset or financial liability in the statement of financial position only when the entity becomes a party to the instrument's contractual provisions. However, IAS 39 includes more extensive guidance when considering whether to derecognize a financial asset.

17.16 Before evaluating whether, and to what extent, derecognition of a financial asset is appropriate, an entity determines whether it should apply the derecognition criteria to the financial asset itself, to part of the financial asset, to a group of financial assets, or to part of a group based on criteria in paragraph 16 of IAS 39.

17.17 After making this determination, an entity should derecognize a financial asset when, and only when

a. the contractual rights to the asset's cash flows expire, or

b. the entity transfers the financial asset and the transfer meets the criteria in IAS 39.

17.18 IAS 39 requires the entity to evaluate the extent to which the entity retains the risks and rewards of ownership of the financial asset as part of this process.

17.19 When a transfer of a financial asset qualifies for derecognition and the entity retains servicing rights for a fee, the entity should recognize either

a. a servicing asset for the servicing right, when it expects the fee to be adequate compensation for its services, recognized at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset, or

b. a servicing liability for its obligation to provide services, when the entity does not expect the fee to adequately compensate it for its services, recognized at fair value.

17.20 When an entity derecognizes a financial asset, it should recognize a gain or loss equal to the difference between the asset's carrying amount and the sum of the consideration received and the cumulative gain or loss, if any, previously recognized in comprehensive income. When the derecognized financial asset is a component of a larger financial asset, and the part transferred qualifies for derecognition in its entirety, the entity should allocate the previous amount of the larger financial asset between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer.

17.21 Not all transfers of financial assets qualify for derecognition. When an entity retains substantially all of the risks and rewards of ownership or, by the extent of its continuing involvement, is exposed to changes in the value of the transferred asset, it should not derecognize the asset. In the former case, the entity should continue to recognize the entire asset and also recognize a liability for the consideration received. In the latter case, the entity should recognize an asset to the extent of its continuing involvement and an associated liability.

17.22 An entity should measure the associated liability recognized pursuant to the preceding paragraph in such a way that the net carrying amount of the transferred asset and the associated liability is either

a. the amortized cost of the rights and obligations retained by the entity (if the transferred asset is measured at amortized cost), or

b. equal to the fair value (if the transferred asset is measured at fair value).

17.23 With respect to noncash collateral, IAS 39 requires that the transferor and transferee account for the collateral in the following manner:

- If the transferee can sell or repledge the collateral, the transferor should reclassify that asset separately from other assets.
- If the transferee sells the collateral, it should recognize proceeds from the sale and a liability for the collateral due to the transferor. If no sale has taken place, the transferor should carry the collateral as an asset.
- In the event that a transferor defaults, it should derecognize the collateral and the transferee should recognize the asset, at fair value. In the event that the transferee has sold the collateral, it should derecognize the obligation to return the collateral.

17.24 An entity has an option under IAS 39 to recognize regular way purchases of financial assets or derecognize sales using either trade date or settlement date accounting, consistently applied.

17.25 An entity should derecognize all or part of a financial liability when the entity has discharged or cancelled its obligation under the contract or when the obligation expires. The entity should consider an exchange of financial instruments as an extinguishment of the original instrument and should recognize a new liability only if the terms of the instruments are substantially different. Similarly, when the terms of the original obligation are substantially modified, the entity should account for the modification as an extinguishment of the existing liability and recognition of a new liability. The entity should recognize the difference between the carrying value of a financial liability, that was extinguished or transferred to another entity, and the consideration paid in profit or loss.

17.26 IAS 39 requires an entity to recognize a financial asset or financial liability initially as its fair value, minus transaction costs, directly attributable to its issue, in the case of a financial liability not at fair value though profit or loss.

17.27 Subsequent measurement depends on the classification of the financial instrument on initial recognition. After initial recognition, unless designated as a hedged item, an entity should measure its financial assets including derivatives, at fair value, excluding transaction costs with the exception of the following:

- An entity should measure loans, receivables, and HTM investments at amortized cost using the effective interest method.
- An entity should measure other financial instruments at cost, including the following:
  - Investments in equity instruments without a quoted market price in an active market and whose fair value cannot be measured reliably.
  - Derivatives linked to and with required settlement by such unquoted instruments.

17.28 Similarly, unless designated as a hedged item, an entity should subsequently measure all financial liabilities at amortized cost using the effective interest method, with the exception of the following:

- An entity should measure at cost derivatives linked to, and with required settlement by, delivery of an unquoted equity instrument whose fair value cannot be measured reliably.
- An entity should measure financial liabilities at FVTPL at fair value.
- An entity should measure financial guarantee contracts and commitments to provide a loan at below fair market value at the higher of the following amounts:
  - The amount determined in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
  - The amount initially recognized less the cumulative amortization, if any, recognized in accordance with IAS 18.

17.29 IAS 39 contains substantive application guidance on recognition and measurement, including fair value measurement. Appendix A, "Application Guidance," of IAS 39 is considered an integral part of the standard and application of its guidance is mandatory. In contrast, the implementation guidance that accompanies the standard is not considered part of the standard and application of its guidance is not mandatory.

17.30 An entity may need to reclassify a financial asset or financial liability because the entity's intention with respect to that instrument changed or its fair value can no longer be measured reliably. IAS 39 prohibits an entity from reclassifying financial assets or financial liabilities in the following circumstances:

- Out of the FVTPL category:
  - Derivatives when held or issued
  - Instruments designated at FVTPL at initial recognition, generally
- Into the FVTPL category: Any financial instrument after initial recognition

17.31 However, in certain circumstances, IAS 39 permits an entity to reclassify nonderivative financial assets (other than those designated at FVTPL at initial recognition) out of the FVTPL category. The standard also permits an entity to transfer a financial asset from the AFS category to the loans and receivables category when the following two criteria are met:

- The financial asset would have met the definition of loans and receivables if the entity had not classified it as AFS.
- The entity has the intention and ability to hold that financial asset for the foreseeable future.

17.32 However, in rare circumstances when specific conditions are met, an entity may reclassify a financial asset no longer held for trading (selling or repurchasing in the near term) out of the FVTPL category.

17.33 When an entity no longer has the intent or ability to hold an investment to maturity, it should reclassify an HTM investment as AFS and remeasure the investment at fair value. The entity should recognize the difference between the carrying amount and fair value in other comprehensive income until the entity derecognizes the asset. However, when an entity reclassifies more than an insignificant amount of HTM investments to AFS, it should reclassify all of its remaining HTM investments and not classify any new investments as HTM until two years have elapsed.

17.34 An entity should recognize gains or losses from changes in fair value on instruments that are not part of a hedging relationship, depending on their classification. An entity should recognize such gains or losses in profit or loss when the instrument is classified as FVTPL, and in other comprehensive income when the instrument is classified as AFS. For instruments held at amortized cost, an entity should recognize a gain or loss in profit or loss when the financial asset or financial liability is derecognized or impaired, and through the amortization process, unless the instrument is part of a hedging relationship.

17.35 At the end of each reporting period, an entity should review its financial assets or groups of such assets and determine whether objective evidence of impairment exists. When such evidence exists for financial assets held at amortized cost, the entity should measure the amount of the loss as the difference between the carrying value of the asset and the present value of future cash flows discounted at the original effective interest rate. The entity should recognize this loss in profit or loss. The entity may reduce the carrying amount of the asset directly or use a valuation allowance.

17.36 An entity should recognize a reversal of this impairment loss if it can attribute the decrease in the loss to an event that occurred after it recognized the original loss. An entity should not increase the carrying amount of the asset above the amount that would have resulted if the impairment had not been recognized. When the entity determines that an AFS financial asset is impaired, it should reclassify the cumulative loss previously recognized in equity to profit or loss as a reclassification adjustment. An entity should not reverse an impairment loss recognized on equity instruments classified as AFS. However, the entity should reverse an impairment loss on an AFS debt instrument subject to the same constraints as a reversal on an instrument held at amortized cost.

17.37 In accordance with IAS 32, an entity should recognize in profit or loss interest and dividend income and interest expense on financial instruments within its scope.

Hedge Accounting

17.38 IAS 39 provides special accounting treatment for hedged items and hedging instruments in a designated hedging relationship. Hedge accounting permits the offsetting of gains or losses from changes in fair value of the hedged item and hedging instrument. Certain conditions and constraints exist for an instrument to qualify as either a hedging instrument or hedged item and for designation of the hedging relationship. The hedging relationship should also meet an effectiveness test in order for the entity to apply hedge accounting.

17.39 IAS 39 recognizes two types of hedging relationships: fair value hedge and cash flow hedge. IAS 21, *The Effects of Changes in Foreign Exchange Rates*, further recognizes an additional type of hedging relationship—a hedge of a net investment in a foreign operation. An entity that hedges its net investment in a foreign operation should account for the hedging relationship similar to a cash flow hedge.

17.40 To qualify as a hedging relationship, a relationship should meet the following criteria in IAS 39:

- At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and the strategy for creating the hedge.
- The hedge is expected to be highly effective in achieving the stated goal and an offsetting of changes in fair value or cash flows, consistent with the documented risk management strategy for the particular hedge.
- For cash flow hedges related to a forecast transaction, this transaction must be highly probable and must present an exposure to variations in cash flows that could affect profit or loss.
- The effectiveness of the hedge must be able to be reliably measured.
- The hedge must be assessed on an ongoing basis and must be determined to be highly effective during the reporting periods for which the hedge was designated.

17.41 IAS 39 states that for a fair value hedge, an entity recognizes in profit or loss gains and losses from remeasuring the hedging instrument at fair value for properly designated cash flow hedge. The entity should adjust the carrying value of the hedged item for the gain or loss attributable to the hedged risk should and recognize the same effect in profit or loss.

17.42 IAS 39 requires an entity to discontinue hedge accounting prospectively when

a. the hedging instruments expire or is sold, terminated or exercised;

b. the hedge no longer meets the criteria for hedge accounting; or

c. the entity revokes the designation.

17.43 For the purposes of applying the requirement of the previous paragraph, an entity should not consider the replacement or rollover of a hedging instrument into another hedging instrument to be an expiration or termination, if such replacement or rollover is part of the entity's documented hedging strategy.

17.44 An entity should amortize to profit or loss any adjustment to a financial instrument, for which the effective interest method is used, that arises from a change in the carrying amount of a hedged item, attributable to the hedged risk. The entity should base the adjustment on a recalculated effective interest rate at the date amortization begins. The entity should begin amortization as soon as the adjustment is made but no later than when the hedged item ceases to be adjusted for changes in the hedged risk. For a fair value hedge of interest rate exposure of a portfolio, this method may not be practicable. In this case, IAS 39 allows the entity to use straight-line amortization.

17.45 IAS 39 states that for a cash flow hedge, an entity should recognize in other comprehensive income gains and losses from a hedge deemed effective, or for the portion deemed effective. The entity recognizes the ineffective portion of the hedge in profit or loss.

17.46 An entity should reclassify gains or losses arising from a hedged forecast transaction, which results in the recognition of a financial asset or liability from other comprehensive income into profit or loss as a reclassification adjustment under IAS 1, *Presentation of Financial Statements*, in the period or periods that the hedged forecast cash flows affect profit or loss. An entity should reclassify into profit or loss the amount of any portion of a loss recognized in other comprehensive income that the entity does not expect to recover in a future period.

17.47 IAS 39 requires that an entity adopt and adhere to an accounting policy related to the treatment of gains and losses arising from a hedged forecast transaction that results in the recognition of a nonfinancial asset or liability, or becomes a firm commitment where fair value hedge accounting is applied. The entity may choose to adopt either of the following policies:

- Reclassify the associated gains and losses following the guidance of a basic cash flow hedge, separating the gains and losses between the effective or ineffective portions of the hedging instrument.
- Remove the associated gains and losses that were recognized in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability.

17.48 In accordance with IAS 1, for cash flow hedges other than those resulting in financial or nonfinancial assets or liabilities, or resulting in firm commitments, an entity should reclassify into profit or loss amounts that had previously been recognized in other comprehensive income in the same period or periods that the forecast cash flows affect profit or loss.

17.49 An entity should discontinue hedge accounting for cash flow hedges if the hedging instrument is extinguished, the hedge no longer meets the criteria for initial recognition, the forecasted transaction is not expected to occur, or the entity revokes the designation.

17.50 IAS 39 requires that an entity account for hedges of a net investment in a foreign operation in a manner similar to that for a cash flow hedge. IAS 21 provides additional guidance on the accounting for these hedges.

Presentation

17.51 IAS 32 requires an entity, on initial recognition, to classify a financial instrument or its components as a financial asset, a financial liability, or an equity instrument in accordance with the substance of the contractual arrangement and the definitions applicable to these items. When distinguishing between a financial liability and an equity instrument, an entity should only classify the item as equity when the following two conditions are met:

- The entity has no contractual obligation to deliver cash or to exchange financial assets or liabilities under potentially unfavorable conditions.
- If the entity settles the instrument with its own shares, the instrument is either a nonderivative instrument with no contractual obligation to deliver a variable number of shares or a derivative that will be settled only by the entity exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

17.52 If the instrument does not meet these conditions, the entity should classify the instrument as a financial liability.

17.53 A *puttable instrument* is a financial instrument that either gives the holder the right to return (put back) the instrument to the issuer for cash or another financial asset or is automatically returned to the issuer on the occurrence of an uncertain future event, or the death or retirement of the instrument holder. As described previously, this instrument is an exception to the definition of a financial liability. An entity should classify this instrument as equity when it has certain features established in IAS 32, including the following:

- In the event of liquidation, the holder is entitled to a pro rata share of the entity's net assets.
- The instrument is subordinate to all other financial instruments (that is, it has, and conversion is unnecessary for it to have, no priority over other claims).

17.54 An entity should reclassify an instrument as equity or a financial liability as of the date that the necessary conditions for these classifications are met, or are no longer met, respectively. IAS 32 also provides guidance on liability or equity classification when contingent settlement provisions and settlement options exist. Certain instruments, known as compound financial instruments, contain both a liability and an equity component. Based on the measurement criteria identified in IAS 32, an entity should classify each component separately as financial assets, financial liabilities, or equity and account for each component accordingly.

17.55 An entity should account for treasury shares as a reduction of equity. An entity should not recognize gains or losses on Treasury share transactions in profit or loss. IAS 1 requires an entity to disclose treasury shares separately either on the face of the balance sheet or in the notes.

17.56 An entity should offset a financial asset and financial liability only when it has a legally enforceable right to offset and intends to settle net or simultaneously. When a transferred financial asset does not qualify for derecognition, an entity should not offset the transferred asset against any related liabilities. IAS 32 provides examples, including synthetic instruments, that would generally not qualify for a net presentation on the statement of financial position.

Disclosure

17.57 IFRS 7 requires certain disclosures by class of financial instrument. A class of instrument is different from the IAS 39 categories previously discussed (for example, HTM or FVTPL). A *class of instrument* is a grouping of instruments that is appropriate to the information disclosed (for example, corporate bonds). An entity may include instruments in the same class in different categories depending on the entity's intentions with respect to those instruments. For example, an entity may designate a particular bond as FVTPL and classify all other bond investments as AFS, even though it considers all bonds investments to be a single class of financial assets. IFRS 7 requires an entity to provide sufficient detail so users can reconcile the information in the note disclosures to the amounts on the balance sheet.

17.58 An entity should separately disclose the amounts of financial assets and the amounts of financial liabilities in each IAS 39 category. When financial assets or financial liabilities are designated at FVTPL, an entity should disclose additional information. When a loan or receivable or financial liability is classified at FVTPL, an entity should disclose information about various risks, including changes in fair value due to changes in credit risk, changes in market conditions that give rise to market risk (such as, changes in interest rates), and the methods used to determine these effects.

17.59 An entity should also disclose additional information about any reclassifications during the period, including amounts reclassified, carrying amounts and fair values of instruments reclassified, and amounts that would have been recognized in profit or loss if the entity had not reclassified the instrument.

17.60 When an entity has transferred financial assets that did not qualify for derecognition, it should disclose the nature of these assets, the nature of the risks and rewards to which it remains exposed, the carrying amount of the recognized assets, and the amount of the original assets when the remaining balance sheet measurement relates only to its continuing involvement.

17.61 With respect to items on the statement of financial position, an entity should also disclose information about collateral, allowances for credit losses, defaults, and breaches.

17.62 With respect to the statement of profit or loss or other comprehensive income, an entity should separately disclose net gains or losses recognized for each IAS 39 category of financial assets and liabilities, total interest income, total interest expense on instruments not held at FVTPL, fee income and expense separately for instruments not held at FVTPL, trust and fiduciary activities, interest income on impaired financial assets, and the amount of any impairment losses for each class of financial asset.

17.63 An entity should disclose its accounting policies in accordance with IAS 1, including the measurement bases applied.

17.64 With respect to hedge accounting, an entity should disclose descriptions of the hedge and the hedging instruments used with fair values and the nature of the risks hedged, separately, for fair value hedges, cash flow hedges, and hedges of net investments. IAS 39 requires additional disclosures for each type of hedge. In addition, for each class of financial asset and financial liability, an entity should disclose the fair value of the class in such a way that it can be compared with the carrying amounts of these classes.

17.65 An entity should disclose the fair value of each class of financial asset and liability and the methods, valuation techniques (if any), and the assumptions used in determining fair value, except when the financial instrument

a. has a carrying amount that approximates fair value,

b. is held at cost under IAS 39 because its fair value cannot be measured reliably, or

c. contains a discretionary feature and the fair value of that feature cannot be measured reliability.

17.66 In providing these disclosures, the entity should also classify fair value measurements using the following fair value hierarchy:

- Level 1: Fair values obtained from quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Fair values obtained using inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3: Fair values are obtained using inputs for the asset or liability that is not based on observable market data.

17.67 For fair value measurements disclosed in the balance sheet, an entity should disclose the relevant level in this hierarchy, disclose and explain any significant transfers between levels 1 and 2, and reconcile the beginning and ending balances in the balance sheet account for level 3 measurements. For level 3 measurements, the entity should disclose the sensitivity of the measurement to changes in inputs and how this change was calculated.

17.68 An entity should also disclose both qualitative and quantitative information about the nature and extent of their risk exposure arising from financial instruments. These risks include, but IAS 39 does not limit these risks to, credit risk, liquidity risk, and market risk. An entity should provide both qualitative and quantitative disclosures about these risks. *Qualitative disclosures* include the entity's objective, policies, and processes used to manage that particular risk and any changes from the prior period. An entity should base quantitative disclosures on the information provided internally to management (for example, the board of directors). An entity should disclose when the required information is not provided because the effect is not material and should discuss concentrations of risk not apparent from the other disclosures provided. IAS 39 also requires sensitivity analysis for market risks.

17.69 An entity should also disclose any additional information required by IAS 1.

Chapter 18

Noncurrent Assets Held for Sale and Discontinued Operations

Overview

18.01 Entities sometimes sell or distribute to shareowners noncurrent assets (such as property, plant, and equipment) or a group of such assets with associated liabilities (referred to as a disposal group). An entity should classify the assets or disposal group as held for sale when it makes a decision to sell or distribute such assets or a disposal group and concludes that it will recover the carrying amount(s) primarily through sale rather than continued use. This occurs when all of the following conditions are met for an asset or disposal group:

- Available for immediate sale
- In its current condition
- Subject only to usual and customary terms of sale
- Sale is highly probable

18.02 Therefore, the entity presents separately these noncurrent assets and any associated liabilities in a disposal group as current assets and current liabilities in the entity's statement of financial position. On reclassification, the entity immediately measures the assets at the lower of its carrying amount and fair value less costs to sell (or distribute, as appropriate) and stops recording depreciation or amortization on these assets even if they continue to be used.

18.03 An entity may also decide to discontinue and sell a component of its business operations such as a separate major line of business or geographic area. When both of the following two criteria are met, the entity classifies the component as a *discontinued operation*:

- The entity can clearly distinguish the operations and cash flows of the component from those of other operations of the entity, both operationally and for financial reporting purposes.
- The entity has a single coordinated plan to dispose of the component.

18.04 The entity then classifies the assets and associated liabilities of the discontinued operation as held for sale in the statement of financial position and presents separately in the statement of profit or loss and other comprehensive income the net of the after-tax results of operations and any after-tax gain or loss on the sale or disposal of the component. The entity also accounts for any subsidiaries acquired exclusively for resale in the same manner.

18.05 This chapter describes the measurement of assets held for sale and provides additional guidance on classification, presentation, and disclosure of the entity's noncurrent assets held for sale and discontinued operations.

Summary of Selected Accounting Guidance

18.06 International Financial Reporting Standard (IFRS) 5, *Non-current Assets Held for Sale and Discontinued Operations*, is the primary authoritative literature relating to the accounting for noncurrent assets held for sale and the presentation and disclosure of discontinued operations.

18.07 This chapter and IFRS 5 provide guidance for the measurement, classification, and presentation of an entity's recognized noncurrent assets or disposal groups that are classified as held for sale, including noncurrent assets or disposal groups held for distribution to owners.

Scope and Scope Exclusions

18.08 The classification and presentation requirements in IFRS 5 apply to all noncurrent assets, disposal groups, and components of an entity that meet the criteria for classification as held for sale or discontinued operations.

18.09 IFRS 5 excludes the specific noncurrent assets, either individually or when they are part of a disposal group, from its measurement requirements. Instead, the entity measures these assets as follows:

- Deferred income tax assets in accordance with International Accounting Standard (IAS) 12, *Income Taxes*
- Assets arising from employee benefits in accordance with IAS 19, *Employee Benefits*
- Financial assets within the scope of IAS 39, *Financial Instruments: Recognition and Measurement* (or IFRS 9, *Financial Instruments*, when adopted) in accordance with that standard
- Investment property measured at fair value in accordance with IAS 40, *Investment Property*
- Biological assets measured at fair value in accordance with IAS 41*, Agriculture*
- Contractual rights under insurance contracts in accordance with IFRS 4, *Insurance Contracts*

18.10 A disposal group may consist of assets alone or assets with associated liabilities (for example, a building with a related mortgage). A disposal group may be a cash generating unit (CGU) itself or be part of a CGU. A disposal group may also contain assets and liabilities that are implicitly or explicitly excluded from the measurement requirements of IFRS 5. (For example, current assets, such as accounts receivable, are implicitly excluded and deferred income taxes are explicitly excluded from the measurement criteria in IFRS 5.)

Classifications

Held for Sale

18.11 An entity classifies a noncurrent asset or disposal group as held for sale when the asset or disposal group is

a. available for immediate sale,

b. in its present condition,

c. with terms of sale that are usual and customary, and

d. the sale is highly probable.

18.12 An entity should consider a sale highly probable when

a. the appropriate level of management has, and is committed to, a plan to sell the noncurrent assets or disposal group.

b. management is seeking a buyer by actively marketing the sale of the noncurrent assets or disposal group.

c. the price is reasonable in relation to the fair value of the noncurrent asset or disposal group.

d. the entity expects the sale to qualify for recognition as a completed sale within one year from the date of the held for sale classification.

e. actions required to complete the plan should indicate that it is unlikely that the plan will change significantly or be withdrawn.

f. if necessary, the entity considered whether it needed shareholder approval when it determined the sale was highly probable.

18.13 An entity should also consider noncurrent assets held for exchange for other noncurrent assets to be held for sale when the exchange has commercial substance in accordance with IAS 16, *Property, Plant and Equipment*.

18.14 IFRS 5 permits some exceptions to the one-year requirement when the delay is caused by facts and circumstances beyond the entity's control. However, the entity should have sufficient evidence to support management's commitment to the original sales plan. Appendix B of IFRS

5 provides several examples in which such delays may arise. For example, an exception to the one-year requirement can apply in the following circumstance:

> An entity meets all of the criteria to classify a disposal group as held for sale except it knows that a third party (neither the seller nor the buyer) will impose conditions on the transfer of the asset. Such third parties could include lenders, noncontrolling interests, regulators, or other governmental entities. Until a firm purchase commitment is obtained from the buyer, the entity cannot know whether or what conditions will be imposed and it cannot initiate the actions that would be needed to respond to or resolve those conditions. Once the conditions are known, it may become clear to the entity that, despite its initiating timely actions to favorably resolve the conditions, the time to complete the sale will exceed the one-year requirement.

Noncurrent Assets or Disposal Groups Acquired With the Intent to Resell

18.15 The same basic criteria for classification as held for sale applies when an entity specifically acquires a noncurrent asset or disposal group with the intent to resell. However, the entity can classify the noncurrent asset or disposal group as held for sale at the acquisition date when the highly probable criteria, including the one-year requirement, are met at that date and it meets the remaining criteria within a short period of time (usually three months) after the acquisition date. For example, it may take the entity a couple of months to improve the condition of the acquired assets or disposal group available for immediate sale in their present condition.

18.16 If the entity does not expect to meet all of the criteria described previously for classification as held for sale within a short period of time from the acquisition date, it should not classify the noncurrent assets or disposal group as held for sale. In addition, if all of the criteria for held for sale classification are not met at the reporting date, the entity should not classify the acquired assets or disposal group as held for sale even if the criteria are met after the reporting date but before the financial statements are authorized for issuance. However, the entity should disclose in the notes to the financial statements a description of the assets or disposal group; the facts, circumstances, and expected timing of the sale or expected disposal; and the amount of any gain or loss to be recognized in the statement of profit or loss and other comprehensive income in the notes to the financial statements. For additional disclosure requirements, refer to paragraph 18.49.

18.17 *Guidance on Implementing IFRS 5*, included in part B of *International Financial Reporting Standards*, includes a series of examples illustrating the following issues: (*a*) assessing availability for immediate sale, (*b*) classifying of subsidiaries acquired with the intent to resell, and (*c*) assessing exceptions to the one-year requirement. The following examples provide additional guidance on these issues.

Example 18-1: Assessing the Available for Immediate Sale Criteria

Facts

- A regional car rental company, Tri-State, is committed to a plan to sell its fleet of luxury vehicles (for example, Jaguar, Rolls Royce, and the like) with all existing lease contracts and discontinue that part of its operations. The company leases its cars in 3 states: North Carolina, South Carolina, and Georgia.
- At the plan commitment date, Tri-State has several outstanding short-term (3 months or less) lease agreements in North Carolina and South Carolina. In addition, a long-term customer in Georgia has an existing lease contract outstanding for Tri-State's most expensive Rolls Royce with 18 months remaining on the lease.

Scenario 1: Tri-State intends to sell its luxury car operations in their entirety to a buyer willing to take over the lease with its Georgia customer. Tri-State has already initiated activities to identify potential buyers and believes that it will find a buyer willing to assume all of the assets and associated liabilities of this disposal group.

Analysis

Tri-State believes that it will find a buyer to purchase all of the vehicles and the outstanding lease contract with the Georgia customer. The existence of the lease contract with the Georgia customer is an associated liability in the disposal group and would be transferred to the buyer when the sale is completed. Therefore, Tri-State meets the criterion that the asset is available for immediate sale at the plan commitment date.

Scenario 2: Tri-State would like to sell its luxury car operations in their entirety to a buyer willing to take over the lease with its Georgia customer. However, Tri-State has already initiated activities to identify potential buyers and has discovered that those car rental companies active in all three states already have luxury car divisions. At the reporting date, Tri-State has identified only one company, Carolina Luxcar, operating in both North Carolina and South Carolina that has expressed an interest in its vehicles and is willing to assume all lease obligations in those states. Because Luxcar does not operate in Georgia, it is unwilling to assume the Tri-State's lease obligation to its Georgia customer.

Analysis

Based on information available at the reporting date, Tri-State does not expect to be able to transfer the disposal group to a buyer "in its present condition" because the identified buyer will not assume all of the lease obligations of the disposal group. Given the remaining term on the Georgia lease, Tri-State would not meet the requirement to complete the sale within one year.

To remedy this situation, Tri-State could try to renegotiate the lease contract with its customer to meet the one-year requirement. Alternatively, it could transfer the leased vehicle to one of the operations it retains, fulfill the lease obligation itself, and then sell the asset separately when the customer returns the vehicle. If Tri-State removes the leased vehicle from the disposal group, it should still classify the disposal group as held for sale as long as the criteria for that classification are still met. The vehicle transferred out of the disposal group would no longer be classified as held for sale and subject to remeasurement as described in paragraph 18.26.

Example 18-2: Assessing an Exception to the One-Year Requirement

The following example illustrates a situation in which a manufacturer's commitment to sell its facility would meet the exception to the one-year requirement in which the time to complete the sale of a noncurrent asset is extended due to events or circumstances beyond the manufacturing entity's control. This example is similar to example 6 of *Guidance on Implementing IFRS 5*.

Facts

- Defense Systems Incorporate (DSI) decides to sell its missile control systems operations (disposal group). These operations include the design and manufacturing of missile control systems under defense contracts with the government in its home country.
- On the date that all of the relevant criteria for held for sale and discontinued operations are met, DSI classifies the disposal group as held for sale and a discontinued operation.
- Given the nature of the contracts with the government, DSI knows that it requires the government's approval of the buyer before the sale can be completed and that there is risk that the government will not approve sale of the disposal group in its entirety.
- DSI obtains a firm purchase commitment from a buyer from another country. Consequently, the government does not approve sale of the disposal group in its entirety to the identified buyer. For example, the government did not approve transfer of certain intangible assets related to the design of its missile control systems to a foreign buyer.
- Therefore, the government requires DSI to retain these intangible assets.
- DSI immediately begins to renegotiate the terms of the sale with the buyer and believes that the renegotiation will result in a favorable outcome, both for itself and to the government's conditions.
- However, DSI also knows that the renegotiation and transfer of intangible assets and associated operations to another of its divisions will result in its not completing the sale within the one-year period required.

Analysis

The government's conditions are outside DSI's control. Because DSI acts in a timely manner to favorably resolve the conditions, it is likely that DSI meets the criteria for an exception to the one year time period to complete the same and need not change the classification as held for sale.

Held for Distribution to Owners

18.18 An entity classifies a noncurrent asset or disposal group as held for distribution to owners when it is committed to the distribution and the asset or disposal group is

a. available for immediate distribution,

b. in its present condition, and

c. distribution is highly probable.

18.19 An entity should consider the distribution highly probable when

- the entity initiates the necessary actions expects to complete the distribution within one year.
- it is unlikely that the entity will significantly change or withdraw the distribution.
- the entity considered and acquired shareholder approval, if necessary.

Noncurrent Assets That Are To Be Abandoned

18.20 An entity does not classify as held for sale noncurrent assets or disposal groups that an entity plans to abandon because the entity would still principally recover their carrying value through continued use, not sale. This rationale also applies to noncurrent assets and disposal groups that are near the end of their economic life or will be closed, not sold. If the disposal group meets the requirements for classification as a discontinued operation, the entity should present its results and cash flows accordingly at the date that it stops using the disposal group. Refer to paragraphs 18.36–.44 for a discussion regarding presentation of a discontinued operation.

18.21 However, paragraph 14 of IFRS 5 states that an entity does not account for a temporarily idle asset as though it were abandoned. The following example, similar to example 8 in *Guidance on Implementing IFRS 5*, illustrates when an asset has not been abandoned.

Example 18-3: Assessing When an Asset Has Not Been Abandoned

Facts

Tot'em Trucking (TT) has five midsize trucks classified as noncurrent on its statement of financial position. During peak demand periods, all five trucks are in service. Demand for trucking has declined in the last few months and TT took two of the trucks off the road and has parked them in its garage. However, TT continues to maintain the trucks in working order so that it will be able to resume their use when demand increases.

Analysis

Because TT continues to maintain the trucks and intends to resume use at some future date, TT does not regard the trucks as abandoned.

Sale of Controlling Interest in a Subsidiary

18.22 When committed to selling the controlling interest in a subsidiary, an entity classifies the assets and liabilities of that subsidiary as held for sale, providing both the criteria described in paragraphs 6–8 of IFRS 5 and paragraphs 18.11–.12 of this chapter are met. The entity classifies the subsidiary as held for sale, even when it will retain a noncontrolling interest afterwards.

Changes to a Plan of Sale

18.23 If the criteria for classification as held for sale are no longer met, the entity should cease classifying the asset or disposal group as held for sale. The entity should also test the noncurrent assets for impairment and measure them at the carrying value of the noncurrent assets or disposal groups before their classification as held for sale or recoverable amount at the date the entity decided not to sell the assets or disposal group. The entity should recognize the adjustment in carrying value in profit or loss from continuing operations and adjust the financial statements retrospectively for all periods since the assets or disposal group was classified as held for sale.

Measurement and Recognition

18.24 Noncurrent assets or disposal groups are measured as follows:

- Noncurrent assets or disposal groups classified as held for sale are measured at the lower of their carrying amount or fair value less costs to sell on the date of this classification. This measurement applies to the initial recognition of any newly acquired assets, even if acquired as part of a business combination. The entity measures costs to sell at present value if it is expected that the sale will occur beyond the one-year period, and recognizes any increase in the present value measurement as financing costs in profit or loss on the statement of profit or loss and other comprehensive income.
- Noncurrent assets or disposal groups classified as held for distribution to owners are measured at the lower of their carrying amount or fair value less costs to distribute. Costs to distribute includes any incremental costs directly associated with the distribution, but does not include income tax or financing costs.

18.25 Prior to classifying assets as held for sale, the entity measures noncurrent assets and assets and liabilities of disposal groups in accordance with applicable IFRSs (for example, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, for liabilities or IAS 12 for income taxes).

18.26 The entity remeasures individual assets and liabilities prior to remeasurement of the disposal group as a whole, which is remeasured at fair value less costs to sell.

Impairment Losses and Reversals

18.27 With respect to noncurrent assets or disposal groups classified as held for sale, an entity should recognize an impairment loss for write-downs of the asset or disposal groups to fair value less costs to sell. Similarly, the entity recognizes an impairment loss for subsequent write-downs except to the extent it had recognized impairment losses on assets or liabilities not subject to the measurement requirements of IFRS 5.

18.28 At some time after classification of assets or a disposal group as held for sale entity and measurement at fair value less cost to sell, an entity may find that fair value less costs to sell has increased. When this increase does not exceed the cumulative impairment loss previously recognized on a noncurrent asset held for sale, in accordance with IFRS 5 or IAS 36, *Impairment of Assets*, the entity will recognize a gain (reversal of impairment loss) in profit or loss on the statement of profit or loss and other comprehensive income. When a subsequent change in fair value less costs to sell relates to a disposal group, the entity should only recognize a gain or less when the gain or loss was not previously recognized.

18.29 The entity recognizes at the date of derecognition any gains or losses from changes in fair value less cost to sell that it had not recognized previously in accordance with applicable guidance in IAS 16 and IAS 38, *Intangible Assets*.

18.30 The entity allocates recognized impairment losses or subsequent gains that reduce or increase the carrying amounts of the noncurrent assets included in a disposal group that are within the scope of IFRS 5 measurement requirements in order set out in paragraphs 104 and 122–123 of IAS 36.

18.31 As long as the criteria for classification as held for sale are met, the entity does not record depreciation or amortization expense on these assets or disposal groups. However, the entity continues to recognize other expenses (for example, maintenance and insurance) and finance costs associated with liabilities included in the disposal group. Example 10 in *Guidance on Implementing IFRS 5* illustrates the allocation of an impairment loss on a disposal group.

Changes to a Plan of Sale

18.32 When the plan to sell the assets or disposal group changes, or assets cease to be included in a disposal group classified as held for sale, and the criteria in paragraphs 18.11–.12 are no longer met, the asset or disposal group will no longer be classified as assets held for sale. When this occurs, the noncurrent assets should be measured at the lower of the

- carrying amount before the held for sale classification, with adjustment for any amortization, depreciation, or revaluations that would have been recognized had the held for sale classification not occurred, and
- recoverable amount at the date of the decision to not sell the noncurrent asset. If the noncurrent asset is part of a CGU, its recoverable amount is the carrying amount that would have been recognized after the allocation of any impairment loss arising on that CGU in accordance with IAS 36.

18.33 Any required adjustments are included in profit or loss from continuing operations in the period when the classification criteria is no longer met. The entity should present the adjustment in the same captions in the statement of profit or loss and other comprehensive income that were used to present recognized gains or losses. If the noncurrent assets had been revalued prior to their classification as held to sale, the adjustment will be an increase or decrease in revaluation in accordance with IAS 16 or 38.

18.34 The removal of individual assets or liabilities from a disposal group classified as held for sale does not in itself change the measurement of the remaining assets and liabilities in the disposal group as long as the disposal group continues to meet the criteria for classification as held for sale. However, if the disposal group no longer meets the criteria for classification as held for sale, the entity would measure at fair value less costs to sell only those noncurrent assets in the disposal group that still meet the held for sale classification criteria. The entity should cease classifying as held for sale any noncurrent asset that does not meet the classification criteria.

Presentation and Disclosure

18.35 The entity presents and discloses noncurrent assets and disposals groups held for sale and discontinued operations in the financial statements in a way that users can evaluate their financial effects.

Discontinued Operations

18.36 Entities are comprised of operations and cash flows. When operations and cash flows can be clearly distinguished from the rest of the entity both operationally and for financial reporting purposes, they are considered to be a component of an entity. A component of an entity can be a either a single, stand-alone CGU, or part of a group of CGUs.

18.37 An entity classifies one of its components as a discontinued operation when the entity has either disposed of the component at the reporting date or classified the component as held for sale in accordance with the classification criteria of IFRS 5 and the component represents a separate major line of business or geographical area of operations. The requirements for classification as a discontinued operation require that the plan to which management is commented be a single coordinated plan to dispose of the separate major line of business or geographical area of operations, or the component is a subsidiary acquired exclusively for resale.

18.38 Paragraphs 33–34 of IFRS 5 require the entity to disclose the following information about a discontinued operation:

- A single net amount in the statement of profit or loss and other comprehensive income that includes the following total amounts:
  - Post-tax profit or loss of discontinued operations
  - Post-tax gain or loss from measurement of the fair value less the costs to sell

- An analysis of the single net amount contained in the following:
  - Revenue and expenses and pre-tax profit or loss of the discontinued operations and related income tax expense in accordance with paragraph 81(h) of IAS 12
  - Any recognized gain or loss on the disposal of assets or disposal group constituting the discontinued operations measured at fair value less the cost to sell and the related income tax expense in accordance with IAS 12

18.39 The entity may present the previous disclosure either on the face of the statement of profit or loss and other comprehensive income or in the notes to the financial statements. If the entity presents this information in the statement of profit or loss and other comprehensive income, it should present the discontinued operations section separately from continuing operations and clearly identified as discontinued operations. In addition, IFRS 5 provides the following guidance:

- For newly acquired subsidiaries that are disposal groups, the entity is not required to provide the previous analysis when, at the time of the acquisition, the subsidiary meets the criteria to be classified as held for sale.
- The entity may disclose the net cash flows attributable to the operating, investing, and financing activities of discontinued operations in either the notes to the financial statements or in the financial statements. The entity is also not required to provide these disclosures for disposal groups that, on acquisition, are newly acquired subsidiaries that meet the criteria to be classified as held.
- The entity may disclose the amounts of income from continuing operations and from discontinued operations attributable to the owners of the parent either in the notes to the financial statements or in the statement of profit or loss and other comprehensive income.

18.40 An entity should not retroactively classify or restate prior period financial statements or disclosures statement relating to any of the previously mentioned disclosures for comparative purposes. The classification as held for sale or discontinued operations and the relevant disclosures are permitted only for the periods when the classification criteria were met and subsequent periods in which the classification criteria continue to be met.

18.41 Paragraph 81 of IAS 1, *Presentation of Financial Statements*, allows entities to present their income and expenses for the period in two separate statements: (*a*) a separate income statement, displaying components of profit or loss, and (*b*) a second statement, the statement of profit or loss and other comprehensive income, beginning with profit or loss and displaying components of other comprehensive income. When an entity elects to present components of profit or loss in the separate income statement a section identified as discontinued operations is presented in a separate income statement.

18.42 The entity classifies any adjustments in the current period to prior period amounts separately in discontinued operations. The entity also discloses the nature and amounts of these adjustments. Examples of how these prior period adjustments may arise in a current period include

- purchase price adjustments with or indemnifications to the buyer,
- resolution of uncertainties arising from and directly related to the operations of the discontinued operation before its disposal (for example, environmental and product warranty obligations that the entity retained), or
- settlement of employee benefit obligations directly related to the disposal.

18.43 When an entity ceases to classify a component as held for sale, it reclassifies and presents in income from continuing operations the results of operations previously shown as a discontinued operation. The entity also states that it has reclassified and changed the presentation of prior period amounts.

18.44 The entity should also disclose all of the information included in paragraph 18.38 in the following circumstances:

- It is committed to a plan to sell a subsidiary that meets the definition of a *discontinued operation*.
- The sales plan involves loss of control over the subsidiary.

Refer to example 11 in *Guidance on Implementing IFRS 5* for an illustrative example of how an entity should present a discontinued operation in the statement of profit or loss and other comprehensive income.

Gains or Losses Relating to Continuing Operations

18.45 An entity includes gains and losses resulting from remeasurement of noncurrent assets or disposal groups in profit or loss from continuing operations unless the assets or disposal groups meets the definition of discontinued operation.

Noncurrent Asset or Disposal Group Classified as Held for Sale

18.46 When noncurrent assets that are part of a disposal group are classified as held for sale, IFRS 5 requires the entity to

- present assets and liabilities in the disposal group separately from the other assets and liabilities in the statement of financial position. (The entity does not present a single net amount of the assets and liabilities in a disposal group.)
- disclose major classes of assets and liabilities separately in the statement of financial position or in the notes. (IFRS 5 does not require these disclosures for newly acquired subsidiaries that meet the criteria for held for sale classification.)
- recognize in other comprehensive income and present separately any cumulative income or expense relating to the held for sale noncurrent assets or disposal group.

18.47 When noncurrent assets or disposal groups are classified and presented as held for sale in the current period, the entity does not reclassify or change their presentation in the prior periods to reflect this new presentation. Refer to example 12 in *Guidance on Implementing IFRS 5* for an illustrative presentation of noncurrent assets or disposal groups classified as held for sale.

Additional Disclosures

18.48 In order to comply with the general requirements in IAS 1 regarding fair presentation of financial statements, the entity may need to make additional disclosure for noncurrent assets or disposal groups classified as discontinued operations or held for sale.

18.49 In the period that the entity classifies a noncurrent asset or disposal group as held for sale or sold, it should disclose the following in accordance with paragraph 41 of IFRS 5:

- A description of the disposal group or noncurrent assets and the facts and circumstances that leading to the sale or expected disposal, along with the expected manner and timing of the disposal
- Gains or losses recognized and, if not separately presented in the statement of profit or loss and other comprehensive income, the caption in the statement of profit or loss and other comprehensive income that includes those gains or losses
- Applicable reportable segment information in which the noncurrent asset is presented in accordance with IFRS 8, *Operating Segments*

18.50 When an entity changes the plan to sell noncurrent assets or disposal groups, IFRS 5 requires it to describe the facts and circumstance regarding its decision and the effect that decision has on the results of operations for the current and any prior periods presented.

Chapter 19

Customer Loyalty Programs

Overview

19.01 This chapter describes the accounting by an entity that grants award credits to its customers as incentives to buy the entity's goods or services. The customer frequently redeems these award credits, often described as "points," for free or for discounted goods or services. An entity may either operate a customer loyalty program on its own or participate in programs operated by third parties. These programs may have one or more of the following characteristics:

- Require a minimum accumulated amount or value of award credits or points
- Be linked to a single purchase or group of purchases
- Be customized over a particular timeframe
- Include the right to claim awards of goods or services provided by the entity or a third party supplier

Summary of Selective Accounting Guidance

19.02 International Financial Reporting Interpretations Committee (IFRIC) 13, *Customer Loyalty Programmes*, is the primary accounting literature for guidance on how an entity recognizes revenue and accounts for its obligations under customer loyalty and incentive programs. When determining how to account for an award credit, an entity follows the recognition and measurement guidance in International Accounting Standard (IAS) 18, *Revenue*. When the contractual obligation is onerous, with respect to providing goods or services in exchange for award credits, the entity applies the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Refer to chapter 11, "Revenue," and chapter 28, "Provisions, Contingent Liabilities, and Contingent Assets," of this book for additional information pertaining to IAS 18 or IAS 37, respectively.

Scope

19.03 The scope of this chapter and IFRIC 13 applies to customer loyalty award credits that

a. an entity grants to its customers as part of a sales transaction and,

b. subject to meeting any further qualifying conditions, the customers can redeem in the future for free or discounted goods or services.

A sales transaction includes providing goods, rendering services, and use of an entity's assets.

Initial Recognition

19.04 In accordance with paragraph 13 of IAS 18, at the time the entity grants the award credits (the initial sale), the entity should account for the sales transaction as follows:

- Identify the award credits as separate components of the sales transaction(s).
- Allocate the fair value of the consideration received or receivable between the award credits and other components of the sale.

19.05 Revenue recognition and measurement depends upon whether the entity provides the goods or services (the awards) itself or if a third party supplies the awards. When the entity provides the awards itself, it should recognize revenue when award credits are redeemed and it has fulfilled its obligations to provide the awards to its customer. The entity should measure revenue as the gross consideration allocated to the award credits because it is acting as the principal in the sales transaction.

19.06 When a third party supplies the award to the entity's customers, the entity should first assess whether it is collecting the consideration allocated to the award credits on its own account (as a principal) or on behalf of the third party (as an agent).

19.07 When the entity collects the consideration as a principal, it should measure the revenue as the gross consideration received or receivable as if it has supplied the awards itself, as described in the preceding paragraph.

19.08 When a third party supplies the awards and the entity collects the consideration on behalf of the third party, the entity should

a. measure revenue as the net amount retained, such as commission income, and

b. recognize the net amount retained as revenue when the third party becomes obligated to supply the award and entitled to receive the consideration. These events may occur as soon as the entity grants the award. Alternatively, if the customer can choose whether to claim an award from the entity or from a third party, these events may occur only when the customer chooses to claim its awards from the third party.

19.09 Some deferred award credits have finite lives whereas others have indefinite lives. For award credits with finite lives, the entity recognizes any deferred revenue related to expired award credits at the expiration date. The entity should periodically review and, when necessary, revise the carrying amount of award credits.

19.10 The cost of the awards the entity will provide in exchange for reward credits sometimes will rise so that the unavoidable costs of meeting its contractual obligation to supply awards will exceed the consideration received or receivable. In these circumstances, the entity has an onerous contract and should recognize a liability for the excess of the cost less the consideration received or receivable in accordance with the guidance in IAS 37 with respect to onerous contracts. Refer to chapter 28 of this book for additional guidance regarding IAS 37 and onerous contracts.

19.11 See the following example of an onerous contract:

An airline has a frequent flyer program and gives its customers 1 air mile per mile flown. It allocates $0.02 of the ticket price per air mile regardless of the amount the customer pays for the flight. At the beginning of the year, the airline provides a list of awards that it will provide its frequent flyers in exchange for a specific number of air miles. The airline determines the amount of air miles required for a third-party reward by dividing the cost its pays the third party by $0.02 and then rounds the number up to the nearest 100 air miles.

A large flat screen television with a cost to the airline of $1,550 per television is 1 of the more popular awards. The catalog shows the television with a redemption value of 78,000 air miles. The airline does not have a contract with the television's manufacturer that locks in the price. During the year, the price of the television increases to $1,700.

If the airline supplies a television in exchange for 78,000 air miles after the price increase, the airline has an onerous contract.

Before price increase:	
Allocation of consideration for 78,000 miles (78,000 × $0.02)	$1,560
Cost to fulfill obligation	(1,550)
Profit	$10
After price increase:	
Allocation of consideration for 78,000 miles (78,000 × $0.02)	$1,560
Cost to fulfill obligation	(1,700)
Loss	$(140)

Measurement

19.12 As noted previously in this chapter, IFRIC 13 requires the entity to allocate the fair value of the consideration received or receivable from the initial sales transaction between the award credits and the other components of the sale. The entity measures the amount allocated to the award credits by reference to their fair value. IFRIC 13 provides additional guidance on measuring fair value of award credits.

19.13 In accordance with the guidance in International Financial Reporting Standard 13, *Fair Value Measurement*, and the appendix, "Application Guidance," in IFRIC 13, an entity should measure fair value based on the assumptions and perspective of the customer holding the award credit, not the entity. The entity should first look to market transactions (preferably, the principal market). But, whether there is an active market for award credits, an entity should apply judgment when determining the fair value of award credits. When there is a quoted market price for award credits, an obvious fair value is an award credit's price in that market.

19.14 When there is no quoted market price, the entity should use another valuation technique to measure fair value, considering the following, as appropriate. The entity may take one or more of the following approaches to determine a reliable fair value:

- Refer to the fair value of the awards available for redemption adjusted for expected
  - forfeitures and the proportion of award credits the entity does not expect customers to redeem,
  - discounts or incentives that would otherwise be offered to customers who have not earned award credits from an initial sales transaction, and
  - risk that the entity would not fulfill its obligation (nonperformance risk).
- Refer to the amount the entity pays to a third party to settle its obligation, adding a reasonable profit margin.
- Reflect the fair values of the range of available awards that the entity expects customers to select when they can choose from a range of different awards.

19.15 The following are examples of how an entity should account for award credits issued to customers when the entity itself will supply the awards. For additional examples, including those involving third parties, refer to the illustrative examples in IFRIC 13.

Example 19-1

Facts

A clothing manufacturer issues an award credit towards a future purchase at the time of a customer purchase, as follows:

- For every jacket sold to its retailers, a clothing manufacturer gives the retailer an award credit of 30 percent off the retailer's next purchase of the same jacket. The manufacturer has issued these award credits to retailers for many years and knows that, historically, retailers will redeem only half of the award credits they receive.
- The clothing manufacturer's selling price of a jacket to retail customers is currency units (CU) 100.
- The selling price of a jacket by competitors that do not give customers such award credits is CU 85.
- A retailer purchases 200 jackets from the clothing manufacturer and received award credits toward future purchases. The retailer subsequently purchases another 100 jackets.

Analysis

The clothing manufacturer records the retailer's initial purchase of 200 jackets as follows:

- Allocation of the fair value of the consideration to revenue and deferred revenue (liability for the award credits):
  - The clothing manufacturer expects that retailers will pay a higher price for its jackets because of the 30 percent discount on future purchases. Retailers will pay CU 70 for additional jackets for an average jacket price of CU 85.
  - Other clothing manufacturers that do not offer the discount charge CU 85 for their jackets.
  - Based on the preceding information, CU 85 is an appropriate estimate of the fair value of a jacket, for a total fair value of CU 85 × 200 = CU 17,000.
  - Therefore, the fair value of an award credit is CU 15, for a total fair value of CU 15 × 200 = CU 3,000.

The clothing manufacturer records the retailer's subsequent purchase of 100 jackets using the award credits as follows:

Dr. Cash	CU 7,000		
Dr. Deferred Revenue		1,500	
Cr. Revenue			CU 8,500

Consideration Received = 100 jackets × CU 70 = CU 7,000

Because the retailer bought an additional 100 jackets, the clothing manufacturer would recognize the cash received and reduce deferred revenue by CU 1,500 (CU 15 ×100), for total revenue of CU 7,000 + CU 1,500, or CU 8.500.

Chapter 20

Distribution of Noncash Assets to Owners

Overview

20.01 Entities will sometimes distribute noncash assets as dividends to its shareowners acting in their capacity as shareowners. An entity may give its *shareowners*, defined as holders of financial instruments classified as equity, a choice to receive either noncash assets or a cash alternative. This chapter addresses how an entity should account for such distributions, including the following:

- When to recognize a dividend payable
- How to measure the dividend payable
- How to account for a difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable

20.02 This chapter does not provide guidance on how shareholders should account for the dividend distribution.

Summary of Selected Accounting Guidance

20.03 International Financial Reporting Interpretations Committee (IFRIC) 17, *Distribution of Non-cash Assets to Owners*, is the primary authoritative guidance for accounting by an entity that distributes noncash assets as dividends to owners who hold the same class of equity instrument and the entity treats equally in the distribution. International Accounting Standards (IAS) 1, *Presentation of Financial Statements*, is the authoritative guidance and requires an entity to present details of dividends recognized as distributions to owners either in the statement of changes in equity or in the notes to the financial statements. Paragraph 7 of IAS 1 defines an *owner* as a holder of instruments classified as equity.

Scope and Scope Exceptions

20.04 The scope of this chapter and IFRIC 17 applies to the following types of nonreciprocal distributions of assets by an entity to its owners acting in their capacity as owners:

- Distributions of noncash assets, such as the following:
  - Property, plant, and equipment.
  - Businesses as defined in International Financial Reporting Standard (IFRS) 3, *Business Combinations*. For additional guidance regarding business combinations, refer to chapter 16, "Business Combinations," of this book.
  - Ownership interests in another entity or disposal groups as defined in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. Refer to chapter 18, "Noncurrent Assets Held for Sale and Discontinued Operations," of this book for additional guidance on IFRS 5.
- Distributions that give owners a choice of receiving either noncash assets or a cash alternative.

20.05 The scope of this chapter and IFRIC 17 only applies to the accounting by an entity that makes a distribution of noncash assets described previously in which all owners of the same class of equity instruments are treated equally. IFRIC 17 does not address the accounting by shareholders who receive the distribution.

20.06 The guidance in IFRIC 17 and this chapter do not apply to the following situations:

- The noncash asset is ultimately controlled by the same party or parties before and after the distribution.

  Therefore, to be outside the scope of IFRIC 17, the group of individual shareowners receiving the distribution must have, as a result of contractual arrangements, collectively the ultimate power to govern the entity's financial and operating powers in order to obtain benefits from its activities. This exclusion applies to the distributing entity's separate, individual, and consolidated financial statements.

- An entity distributes some of its ownership interests in a subsidiary, but retains control.

  An entity accounts for such distributions in accordance with IAS 27, *Consolidated and Separate Financial Statements*, and results in the distributing entity's recognizing a noncontrolling interest in the subsidiary.

Recognition

20.07 An entity recognizes dividends payable on the date

- the divided is declared by the entity (for example, by management or the board of directors), if the jurisdiction requires no further approval, or
- that the authority approves the declaration, if the jurisdiction requires approval by a relevant authority (for example, shareowners).

Measurement

20.08 The entity measures the liability (dividend payable) at the fair value of the noncash assets to be distributed.

20.09 When the entity gives shareowners a choice of receiving either a noncash asset or a cash alternative, it should estimate the dividend payable as the weighted average of the fair values of each alternative; that is, the entity incorporates in its estimation process the fair value of noncash asset and the cash alternative and the associated probability of the owners' selecting each alternative.

20.10 Paragraph 13 of IFRIC 17 requires an entity to review and adjust the carrying amount of the dividend payable at the end of each reporting period and at the date of settlement. The entity recognizes any changes in the carrying amount in equity as adjustments to the amount of the distribution. At settlement, the entity recognizes in profit or loss any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable.

Presentation and Disclosure

20.11 An entity should present any difference between the carrying amount of the asset distributed and the carrying amount of the dividend payable when settled as a separate line item in statement of profit or loss.

20.12 If applicable, an entity should disclose a reconciliation of the carrying amount of dividends payable, including the following:

- The carrying amount of the dividend payable at the beginning and end of the period
- Increases or decreases in the carrying amount of the dividend payable recognized in the period as an adjustment to equity due to a change in the fair value of the assets to be distributed

20.13 If an entity declares a dividend to distribute a noncash asset after the end of the reporting period, but before the financial statements are authorized for issue, paragraph 17 of IFRIC 17 requires an entity to disclose all of the following:

- Nature of the asset to be distributed
- Carrying amount of the asset to be distributed as of the end of the reporting period

- Estimated fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount
- Information about the method used to determine that fair value in accordance with paragraphs 93(b), (d), (g), and (i), and 99 of IFRS 13, *Fair Value Measurement*. Refer to chapter 17, "Financial Instruments," of this book for additional guidance on disclosure of financial instruments.

Chapter 21

Service Concession Arrangements

Overview

21.01 Public sector entities, such as governments or governmental agencies, sometimes partner with private sector entities to deliver major infrastructure assets (for example, roads, tunnels, airports) or public facilities (for example, hospitals or prisons) to the public sector entity or to provide a public service (for example, operate an existing prison or hospital). In International Financial Reporting Standards (IFRSs) and in this chapter, the public sector entity in these partnerships is referred to as the *grantor* and the private sector entity is referred to as the *operator*.

21.02 To better understand the guidance in IFRSs on these arrangements, it is important to distinguish between simple governmental contracts and concession arrangements. A key aspect of a concession arrangement is that the grantor compensates the operator not only by direct payments, but also by giving the operator the right to generate income by exploiting the work or service provided; that is, although the operator may receive some compensation directly from the grantor, the operator is also compensated by payments from the third parties that use the infrastructure assets or services the operator provides. Therefore, the operator, not the grantor, bears the risks, operational or financial or both, of generating income by providing the public service.

21.03 For example, the grantor may enter into a contract with an operator to build a toll road. Although the grantor may compensate the operator directly with tax benefits, the operator's primary compensation comes from its ability to collect tolls from users of the road, at prices set by the grantor, for a period of time specified in the agreement. At the end of the contract term, the toll road reverts to the grantor, which may or may not continue to collect tolls from users of the road.

21.04 Contracts to deliver infrastructure assets are often referred to as work concessions, and contracts to provide services as service concessions. However, in IFRSs and this guidance, the phrase "service concession arrangements" refers to both work and service concessions. These arrangements typically have the following features:

- Generally, the grantor is a public sector entity. In some cases, however, the grantor may be a private sector entity to which a public sector entity has previously subcontracted or assigned its public service responsibility.
- The grantor controls or regulators the services the operator will provide.
- The contract stipulates the initial prices the operator can charge and how prices will be revised over the term of the contract.
- The operator does not merely act as an agent of the grantor but, at least to some extent, manages the grantor's infrastructure and provides related services.
- The operator is obliged to transfer the infrastructure assets to the grantor in a specified condition at the end of the arrangement for little or no incremental compensation. This transfer occurs without regard to which party initially financed it.

21.05 The accounting considerations included in the chapter clarify how the operator applies certain IFRSs to these arrangements. IFRSs do not address the accounting by the grantor for these arrangements.

Summary of Selected Accounting Guidance

21.06 International Financial Reporting Interpretations Committee (IFRIC) 12, *Service Concession Arrangements*, is the primary accounting literature related to accounting for service concession arrangements by operators. Standing Interpretations Committee (SIC) 29, *Disclosure—Service Concession Arrangements*, as amended by IFRIC 12, specifies the disclosures about service concession arrangements described in this chapter and IFRIC 12.

Scope and Scope Exceptions

21.07 The scope of this chapter and IFRIC 12 applies only to the accounting by private sector operators engaged in public-to-private service concession arrangements that meet the following conditions:

- The grantor controls or regulates
  - services the operator provides with the infrastructure,
  - to whom it must provide these services, and
  - price charged.
- The grantor controls any significant residual interest in the infrastructure at the end of the arrangement, whether from ownership, beneficial entitlement, or otherwise.

21.08 As long as the conditions listed in paragraph 21.07 are met, the requirements of IFRIC 12 apply even to arrangements in which the operator uses an infrastructure asset for its entire useful life. IFRIC 12 applies all infrastructure assets used for the purpose of the service arrangement whether the operator

- constructs the infrastructure itself,
- acquires it from a third party, or
- receives access to existing infrastructure assets from the grantor.

21.09 Infrastructure assets are tangible, noncurrent assets. Because service concession arrangements only give the operator the right of access to, not control of, these assets, infrastructure assets within the scope of IFRIC 12 do not meet the definitions of assets held for use or leased assets. Therefore, an operator does not recognize infrastructure assets within the scope of IFRIC 12 as property, plant, or equipment (PP&E) or leased assets.

21.10 However, IFRIC 12 does not apply when an operator previously held and recognized an infrastructure asset as PP&E, or a leased asset prior to its entering into the service concession arrangement. In that case, the operator should continue to apply the guidance in International Accounting Standard (IAS) 16, *Property, Plant and Equipment*, or IAS 17, *Leases*, to such infrastructure assets. These requirements are further discussed in chapter 5, "Property, Plant, and Equipment," and chapter 7, "Leases," of this book.

21.11 The disclosure requirements in SIC 29 apply to all service concession arrangements within the scope of IFRIC 12. Disclosures about certain aspects of service concessions are already addressed in other IFRSs, including IAS 16, IAS 17, and IAS 38, *Intangible Assets*. However, disclosures of other aspects of the arrangements, such as executory contracts, unless they are onerous, are not addressed in other IFRSs. In the latter case, the requirements of SIC 29 apply.

Measurement and Recognition

21.12 The operator recognizes revenue and costs relating to construction or upgrade services for infrastructure assets using the percentage of completion method in accordance with IAS 11, *Construction Contracts*,[1] and relating to operations services in accordance with IAS 18, *Revenue*. The operator measures revenue at the fair value of the consideration received or receivable. When multiple services are provided, the operator should allocate the consideration received or receivable by reference to the relative fair values of the services delivered, when the amounts are identifiable. Refer to chapter 11, "Revenue," of this book for additional guidance on revenue recognition.

21.13 As noted previously, the operator does not control the infrastructure assets and should not recognize PP&E. Therefore, depending upon the nature of the consideration received or receivable, the operator should recognize either a financial asset or an intangible asset. The operator determines the nature of the consideration by reference to the contract terms and, when applicable, contract law.

[1] This book does not include a discussion of the requirements of International Accounting Standard 11, *Construction Contracts*.

Financial Assets

21.14 The operator recognizes a financial asset when the following conditions are met:

- The operator has an unconditional contractual right to receive cash or another type of financial asset directly from the grantor, or from a third party at the direction of the grantor, for construction services. Construction services may include constructing or upgrading an infrastructure asset or maintaining and operating that asset over the term of the contract.
- The grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law.

21.15 According to paragraph 16 of IFRIC 12, the operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator

- a specified or determinable amount, or
- the shortfall, if any, between the amounts received from users of the infrastructure asset and specified or determinable amounts.

21.16 The operator's right to receive cash is considered to be unconditional even if payment is contingent on the operator ensuring that the infrastructure asset meets certain efficiency or quality requirements.

21.17 Financial assets recognized from service concession arrangements are accounted for in accordance with IAS 32, *Financial Instruments: Presentation*; IAS 39, *Financial Instruments: Recognition and Measurement* (to be superseded by IFRS 9, *Financial Instruments*, effective January 1, 2015); and IFRS 7, *Financial Instruments: Disclosures*. The operator classifies amounts due from or at the direction of the grantor as one of the following:

- Loan or receivable
- Available for sale financial asset
- Fair value through profit or loss, if designated at initial recognition and the conditions for this classification are met

For additional guidance regarding financial instruments, refer to chapter 17, "Financial Instruments," of this book.

> ***Author's Note:*** IFRS 9 was issued in November 2009 and again in October 2010, and is effective for annual periods beginning on or after January 1, 2015. IFRS 9 amends the classification and measurement requirements for financial assets recognized in accordance with IFRIC 12. In accordance with IFRS 9, an entity measures the amount due from, or at the direction of, the grantor at either amortized cost or fair value through profit or loss. If the financial asset is carried at amortized cost, IFRS 9 requires the entity to use the effective interest method and to recognize interest income in profit or loss.

Intangible Assets

21.18 The operator recognizes an intangible asset when it receives a right, such as a license, to charge users of the public service provided by the infrastructure asset over the term of the contract. The right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent to which the public uses the service.

21.19 The operator measures intangible assets recognized from service concession arrangements in accordance with IAS 38, which is discussed in further detail in chapter 4, "Intangible Assets," of this book.

21.20 When the grantor pays the operator partly with a financial asset and partly with an intangible asset, the operator should account for each component of the consideration separately.

21.21 For example, as part of the service concession arrangement, the grantor (a state government) paid an operator, in advance, a specified amount of cash to build a prison. The operator also has the right to charge a specified rate per inmate to each municipal government that sends inmates to the prison. The operator recognizes the direct payment from the grantor as a financial asset and the right to charge for use of the prison as an intangible asset.

Contractual Obligations

21.22 The concession agreement sometimes requires an operator to maintain or restore the infrastructure asset to a specific condition or at a specified level of serviceability. The grantor may require the operator to meet these conditions to maintain its license during the contract period or before it returns the infrastructure asset to the grantor at end of the contract period. Except for requirements to upgrade the infrastructure asset, the operator should recognize and measure contractual obligations to maintain or restore the infrastructure asset in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. For additional guidance on IAS 37, refer to chapter 28, "Provisions, Contingent Liabilities, and Contingent Assets," of this book.

Borrowing Costs

21.23 Normally, the operator expenses borrowing costs attributable to service concession arrangements in the period incurred. However, when the operator recognizes an intangible asset for the right to charge for the use of the public service, it should capitalize borrowing costs attributable to the arrangement during construction of the infrastructure asset in accordance with IAS 23, *Borrowing Costs*. For additional guidance regarding IAS 23, refer to chapter 24, "Borrowing Costs," of this book.

Items Provided By the Grantor

21.24 In addition to infrastructure assets, a grantor may provide other assets to the operator as part of the consideration payable under the agreement. Such assets are not accounted for as government grants in accordance with IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. Therefore, if it can retain or dispose of these assets at its sole discretion, the operator should recognize these assets separately. The operator measures these assets at fair value on initial recognition. The operator also recognizes a corresponding liability for any unfilled obligations it assumed in exchange for the assets. For other asset types provided by a grantor, refer to IAS 20 and chapter 12, "Accounting for Governmental Grants and Disclosure of Governmental Assistance," of this book.

Disclosure

21.25 In accordance with SIC 29, an operator should consider all aspects of a service concession arrangement in determining the appropriate note disclosures. Operators should disclose the following information in each period, in accordance with paragraphs 6 and 6a of SIC 29:

- Description of the arrangement
- Significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows
- Nature and extent of the following:
  - Rights to use the specific assets
  - Obligations to provide or rights to expect provision of services
  - Obligations to acquire or build items of PP&E
  - Obligations to deliver or rights to receive specified assets at the end of the concession period
  - Renewal and termination options
  - Other rights and obligations
- Changes in the arrangement occurring during the period
- How the service arrangements are classified
- Amounts of revenue and profits or losses recognized in the period on exchanging construction services for a financial asset or an intangible asset

21.26 The operator should provide these disclosures either separately for each service concession arrangement or in the aggregate for each class of service concession arrangement. The operator determines a class as a group of service concession arrangements involving services of a similar nature (for example, toll collections, telecommunications, and water treatment services).

21.27 As noted previously, other IFRSs may require additional disclosures depending upon the nature of the asset or liability recognized.

Chapter 22

Foreign Currency Translation

Overview

22.01 An entity may conduct some or all of its activities in a foreign currency; that is, a currency that differs from the currency of the primary economic environment in which it operates (*functional currency)*. These activities involve transactions in a foreign currency and may result in balances, assets, and liabilities in that currency as well. These activities can take the following forms:

- The entity itself may make purchases or sales in a foreign currency.
- The entity may have an operation that transacts most, if not all, of its business in a currency that differs from the functional currency of the entity as a whole and that keeps its books and records in that foreign currency.
- The entity may have a subsidiary in a jurisdiction with a currency that is different from its functional currency of the entity and that keeps its books and records in that foreign currency.

22.02 In order to include these foreign currency activities and balances in either its separate financial statements or consolidated financial statements, at a minimum, the entity needs to convert or translate any foreign currency amounts into its functional currency. Although an entity usually presents its financial statements, separate and consolidated, in that functional currency, International Financial Reporting Standards (IFRSs) permit it to present its financial statements in any currency. When an entity chooses to present is financial statements in a currency different from its functional currency, the entity will also need to convert its functional currency transactions and balances into the presentation currency.

22.03 The methodology used to convert foreign currency amounts into the entity's functional or presentation currency is called *foreign currency translation*. The following definitions are relevant to understanding this process:

- *Functional currency*. The currency of the primary economic environment in which an entity operates.
- *Presentation currency*. The currency in which the financial statements are presented. (The presentation currency is sometimes referred to as the reporting currency.)
- *Monetary items*. Units of currency that an entity holds, or assets or liabilities that an entity expects to receive or pay in fixed or determinable units of currency. (For example, cash, cash dividends, or contracts to receive or deliver a variable number of the entity's own equity instruments, are monetary items. In contrast, amounts prepaid for goods or services; property, plant, and equipment; and liabilities to be settled by delivery of goods or services are nonmonetary items.)
- *Foreign operation*. A subsidiary, associate, joint arrangement, or branch of the entity preparing financial statements. The foreign operation bases or conducts its activities in a country or currency that is different from that of the reporting entity.
- *Net investment in a foreign operation.* The reporting entity's interest in the foreign operation's net assets.

Summary of Selected Accounting Guidance

22.04 International Accounting Standard (IAS) 21, *The Effects of Changes in Foreign Exchange Rates*, is the primary accounting literature on how to account for translation of foreign transactions and balances within its scope.

22.05 An entity applies IAS 39, *Financial Instruments: Recognition and Measurement*, to those derivative transactions and balances within its scope.

> ***Author's Note:*** IFRS 9, *Financial Instruments*, was issued in November 2009 and again in October 2010, and is effective for annual periods beginning on or after January 1, 2015. After IFRS 9 is effective, all references in IAS 29, *Financial Reporting in Hyperinflationary Economies*, to IAS 39 will be replaced with IFRS 9.

22.06 International Financial Reporting Interpretations Committee (IFRIC) 16, *Hedges of a Net Investment in a Foreign Operation*, provides guidance on hedge accounting related to foreign currency risk arising from a net investment in a foreign operation.

22.07 IFRS Standing Interpretations Committee (SIC) 7, *Introduction of the Euro*, provides guidance on the introduction and use of the Euro and its impact on foreign exchange differences.

Scope

22.08 An entity applies IAS 21 when accounting for transactions and balances in foreign currencies, except for derivatives transactions and balances within the scope of IAS 39. IAS 29 also applies when translating the results and financial position of foreign operations that an entity includes in its financial statements by consolidation or the equity method, as well as in translating its results and financial position into a presentation currency.

22.09 IAS 21 does not apply to either the presentation of foreign currency transactions in the statement of cash flows or to the translation of cash flows of a foreign operation. An entity should apply the requirements of IFRS 7, *Financial Instruments: Disclosures*, when addressing these items.

Recognition and Measurement

22.10 On initial recognition, IAS 21 requires an entity to translate a foreign currency transaction to its functional currency by applying the spot exchange rate between the foreign and functional currencies at the date the transaction qualifies for recognition under IFRSs (transaction date).

22.11 When its books and records are kept in the functional currency, at the end of each reporting period, the entity translates any foreign currency monetary items into the functional currency using the closing rate on the balance sheet date. However, how an entity translates foreign currency nonmonetary items into its functional currency depends on the item's measurement basis as follows:

- *Nonmonetary item carried at historical cost*. The entity translates the item's carrying value at the exchange rate on the date of the original transaction.
- *Nonmonetary item carried at fair value*. The entity translates the item's carrying value at the date the entity measured its fair value.

22.12 IAS 21 also includes additional guidance for situations when multiple exchange rates prevailed on this data or there is no exchange rate available.

22.13 When an entity keeps its own books and records in a currency other than its functional currency, the entity should translate all transactions, monetary, and nonmonetary items into its functional currency using the methodology described previously in order to prepare financial statements.

22.14 IAS 21 requires an entity to recognize any exchange differences arising from changes in exchange rates from those used previously, as follows:

- Monetary items: The entity recognizes exchange differences on settlement or translation in profit or loss.
- Nonmonetary items:
  - The exchange component of any gains or losses recognized in profit or loss is also recognized in profit or loss.
  - The exchange component of gains or losses recognized in other comprehensive income is also recognized in comprehensive income.

- Monetary items (receivables and payables) that form part of a net investment in a foreign operation:
  - Recognize these exchange differences in profit or loss in separate financial statements of the entity or individual financial statements of the foreign operation, as applicable.
  - Recognize these exchange differences in other comprehensive income in the consolidated financial statements and reclassify to profit and loss on disposal of the net investment.

22.15 Other IFRSs may require a gain or loss on nonmonetary items to be recognized in other comprehensive income rather than profit or loss (for example, revaluations of property, plant, and equipment carried at revalued amount in accordance with IAS 16, *Property, Plant and Equipment*). In these cases, an entity should also record the effect of any exchange difference in other comprehensive income. However, when an entity recognizes a gain or loss on a nonmonetary item in profit or loss (for example, investment property carried at fair value in accordance with IAS 40, *Investment Property*), it should also recognize any exchange difference in profit or loss.

22.16 When there is a change in its functional currency, an entity should apply the translation procedures in IAS 21 prospectively from the date of change. The entity translates all items into the new functional currency using the exchange rate at the date of change.

22.17 An entity may choose to present its financial statements in a currency other than its functional currency. However, to be in compliance with IFRSs, IAS 21 requires the entity to translate items from its functional currency to the presentation currency as follows:

a. Translate all assets and liabilities for each statement of financial position presented (including comparative items) at the closing rate on the balance sheet date.

b. Translate all income and expenses for each statement of profit or loss and other comprehensive income or separate income statement presented (including comparatives) at the exchange rate on the transaction date (or a rate that approximates these rates).

c. Recognize any resulting exchange differences in other comprehensive income.

Translating the Currency of a Hyperinflationary Economy Into a Presentation Currency

22.18 IAS 21 includes specific requirements for entities that have a functional currency that is the currency of a hyperinflationary economy and choose to use a different presentation currency. IAS 21 requires these entities to translate all amounts at the closing rate on the reporting date of the financial statements. If the functional currency is translated into the currency of a nonhyperinflationary economy, IAS 21 requires the comparative amounts to be those that were presented as current year amounts in the relevant prior year financial statements. The entity does not adjust the comparative amounts for subsequent changes in the price level or exchange rates.

22.19 When the entity's functional currency is the currency of a hyperinflationary economy, IAS 21 requires the entity to restate its financial statements in accordance with IAS 29, prior to applying the translation methods described previously, except for any comparative amounts that are translated into a currency of a nonhyperinflationary economy.

22.20 When the economy ceases to be hyperinflationary, the entity no longer restates its financial statements in accordance with IAS 29. The entity uses the amounts restated to the price level at the date it stopped restating its financial statement as the historical costs for translation into the presentation currency.

Investments in Foreign Operations

22.21 An entity accounts for its investments in foreign operations in one of the following ways:

- When the investment is a joint venture, the entity will account for the investment using the equity method in accordance with IFRS 11, *Joint Arrangements*, and IAS 28, *Investments in Associates and Joint Ventures*;
- When the investment is an associate (that is, the entity has significant influence over the investee), the entity will account for the investment using the equity method in accordance with IAS 28; or
- When the investment is a subsidiary (that is, the entity controls the investee), the entity will present consolidated financial statements in accordance with IFRS 10, *Consolidated Financial Statements*.

22.22 When the entity consolidates the results and financial position of a foreign operation in its financial statements, normal consolidation procedures apply. However, the entity cannot fully eliminate an intragroup monetary asset or liability because the asset or liability represents a commitment to convert one currency into another and exposes the entity to foreign currency risks that would not exist if the currencies were the same. Therefore, IAS 21 requires the entity to recognize these exchange differences in profit or loss or other comprehensive income, as applicable. (See previous discussion of translation of net investments in foreign operations in paragraph 22.14.)

22.23 In addition, the foreign operation may have a different reporting date than the entity's reporting date. IAS 21 permits no more than a three month difference in these reporting dates and requires the entity to adjust translated amounts for the effects of significant transactions or other events occurring between those dates. The same approach is required for investments in foreign operations accounted for using the equity method.

22.24 When an entity acquires a foreign operation, IAS 21 requires the entity to treat any goodwill or fair value adjustments to assets or liabilities of the operation as assets and liabilities of the foreign operation. Therefore, the entity measures the goodwill and fair value measurement adjustments in the operation's functional currency, not the entity's functional currency, and uses the closing rate on the reporting date to translate these amounts into its presentation currency.

22.25 On disposal of the foreign operation, an entity should recognize any cumulative foreign exchange differences as reclassification adjustments from equity (other comprehensive income) to profit or loss at the same time it recognizes any gain or loss on disposal.

22.26 When the entity partially disposes of a subsidiary that includes a foreign operation, the entity should reattribute the proportionate share of the cumulative amount of the exchange differences recognized in equity to any noncontrolling interests in the foreign operation. All other partial disposals require the entity to reclassify to profit or loss only the proportionate share of the cumulative amount of exchange differences previously recognized in equity (other comprehensive income).

Disclosure

22.27 An entity should disclose the following:

- Amount of exchange differences recognized in profit or loss, except those from financial instruments carried at fair value through profit or loss in accordance with IAS 39
- Amount of net exchange differences recognized in equity (other comprehensive income)
- Reconciliation of the amount of such exchange differences at the beginning and end of the period

22.28 When an entity's presentation currency differs from its functional currency, it should disclose this fact, the functional currency, and the reason for using a different presentation currency.

22.29 When an entity changes its own functional currency or the functional currency of a significant foreign operation, it should disclose this fact and the reason for the change.

Convenience Translations

22.30 An entity sometimes provides what is referred to as a convenience translation; that is, in addition to a complete set of financial statements in the presentation currency, the entity also displays some or all of its financial statements or other financial statement information in a different currency from either the presentation or functional currency. Usually, convenience translations are provided in the currency of a jurisdiction where the entity's common shares are publicly traded or where it expects many of its existing shareholders to reside. By providing the convenience translation, the entity expects to better communicate its results and financial position to readers who are more familiar with and able to assess the magnitude of information in this currency. For example, several entities listed on the New York Stock Exchange provide convenience translations in U.S. dollars.

22.31 When an entity provides a convenience translation, it should clearly identify that the information provided is supplemental to the information presented in compliance with IFRSs. The entity should disclose both the display and functional currencies, and the method it used to convert the amounts in compliance with IFRSs and the convenience translation amounts.

Chapter 23

Reporting in Hyperinflationary Economies

Overview

23.01 Hyperinflation is inflation that is out of control. It often occurs when increases in a country's money supply are not supported by its gross domestic product. Hyperinflation can be caused by wars or government flooding its economy by printing money. In both cases, the country's currency loses value. Because market participants fear accepting the currency, they attempt to secure a risk premium by increasing prices, fueling the inflationary spiral.

23.02 Hyperinflation creates a unique problem for financial reporting. Historical cost measurement is the measurement convention entities use for most assets and liabilities. Historical cost assumes that the money value or purchasing power of an entity's functional currency[1] is maintained over fairly long periods of time. However, this assumption is false for a currency of a hyperinflationary economy. An entity that reports using historical cost measurements renders its financial statements useless for investors and creditors in making economic decisions.

23.03 In contrast to historical cost, fair value measurement does not require an assumption of long term stability of an entity's functional currency. Therefore, when an entity's functional currency is that of a hyperinflationary economy, investors, creditors, and other users of the entity's financial statements prefer the entity to use fair value rather than historical cost measurements in its financial statements.

23.04 In addition, money in a hyperinflationary economy loses its purchasing power at such a rapid rate that comparisons of measurements, whether historical cost or fair value, from different periods, even within the same accounting period, are not useful. Therefore, in addition to measuring its current period financial statements at fair value, an entity should restate comparative amounts to current period fair values. Restatement applies to an entity's financial position, results of operations, and all other financial statement information so that users of the financial statements can rely on this information in making their economic decisions.

Summary of Selected Accounting Guidance

23.05 All entities whose own functional currency or the functional currency of any of its foreign operations is that of a hyperinflationary economy should follow the requirements and procedures of International Accounting Standard (IAS 29), *Financial Reporting in Hyperinflationary Economies*, when preparing its financial statements.

23.06 International Financial Reporting Interpretations Committee (IFRIC) 7, *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies*, clarifies the application of IAS 29 in the following circumstances:

- An entity identifies the existence of hyperinflation in the economy of its functional currency.
- The economy was not hyperinflationary in the prior reporting period.

23.07 IAS 21, *The Effects of Changes in Foreign Exchange Rates*, also is relevant for most entities applying IAS 29. In addition to defining a functional currency as the currency of the primary economic environment in which an entity operates, IAS 21 explains the method that an entity applies when translating

- the results and balances of its foreign operations and foreign subsidiaries to be included in its consolidated financial statements, and
- either its consolidated or separate financial statements from a functional currency to a different presentation currency.

[1] As defined in International Accounting Standard 21, *The Effects of Changes in Foreign Exchange Rates*, an entity's *functional currency* is the currency of the primary economic environment in which it operates.

23.08 IAS 21 prohibits entities with hyperinflationary functional currencies from using a stable or hard currency as its measurement unit of account. See chapter 22, "Foreign Currency Translation," of this book for a description of IAS 21 requirements.

Scope

23.09 IAS 29 applies to both the separate and consolidated financial statements of any entity whose functional currency is the currency of a hyperinflationary economy. Because judgment is required in determining whether an economy is hyperinflationary or not, IAS 29 provides indicators of the following characteristics of such an economy:

a. General population tends to keep its wealth in nonmonetary assets or a stable currency. In addition, available funds in a local currency are immediately invested to maintain purchasing power.

b. General population does not refer to prices in the local currency. People may quote prices in a more stable currency.

c. Prices for credit purchase and credit sale transactions take into account estimated changes in purchasing power even when the time between delivery and payment is short.

d. Prices, including interest rates, wages, and so on, may be linked to a price index.

e. Cumulative inflation rate over a 3-year period approaches or exceeds 100 percent.

23.10 Paragraph 4 of IAS 29 states that it is preferable for all entities that report in the currency of the same hyperinflationary economy apply IAS 29 from the same date. Nevertheless, an entity should apply the requirements of IAS 29 to its financial statements from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports.

Recognition and Measurement

23.11 An entity might follow several potential approaches to address the challenge of providing useful financial reporting information when its functional currency is hyperinflationary. However, IAS 29 requires the entity to follow the restatement approach. The restatement approach requires an entity whose functional currency is the local currency of a hyperinflationary economy to restate local currency measurements at the end of the reporting period by applying a general price index.

23.12 An entity restating its financial statements in accordance with IAS 29 would normally take the following actions:

a. Identify a general price index.

b. Restate nonmonetary assets and liabilities on the statement of financial position.

c. Restate items on the statement of profit or loss and other comprehensive income.

d. Calculate any gain or loss on the change in the net monetary position.

e. Restate the statement of cash flows.

f. Restate any comparative financial statements by applying the general price index.

g. Restate comparative information included in note disclosures.

23.13 When an entity's functional currency first becomes hyperinflationary, International Financial Reporting Standards (IFRSs) require the entity to apply the requirements of IAS 29 to its financial statements. The entity applies IAS 29 retrospectively as if its functional currency had always been hyperinflationary.

23.14 The entity also restates the financial statements of a foreign operation in accordance with IAS 29. As defined in IFRSs, a *foreign operation* is an entity that is a subsidiary, associate, joint venture, or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. Similarly, *foreign currency* is defined as a currency that is other than the functional currency of the entity. In accordance with

IAS 21, an entity should restate the financial statements of a foreign subsidiary in accordance with IAS 29 before it translates the subsidiary's financial statements into its functional currency as part of the consolidation process.

23.15 In accordance with IAS 21, an entity translates all assets, liabilities, equity items, income, and expenses at the closing rate at the reporting date of the most recent statement of financial position, including comparatives, except when the financial statements are translated into a *stable currency* (the currency of a normal or nonhyperinflationary economy). When an entity's presentation currency is a stable currency, comparative financial statement amounts are those that the entity presented as current year amounts in the relevant prior year financial statements. The entity does not adjust the comparative amounts for either subsequent changes in the price level or subsequent changes in exchange rates.

23.16 When an economy ceases to be hyperinflationary, the entity previously subject to the requirements of IAS 29 should discontinue preparing and presenting its financial statements in accordance with that standard. The entity uses the measurements at the end of the previous reporting period as the basis for the carrying amounts in subsequent financial statements.

Disclosure

23.17 IAS 29 requires an entity to disclose the following information about its financial statements:

- The fact that the financial statements and prior period comparative information are restated for the changes in the general purchasing power of the functional currency and, as a result, are stated in terms of the measuring unit current at the end of the reporting period.
- Whether the financial statements are based on a historical cost approach or a current cost (fair value) approach.
- The identity and level of the price index applied at the end of the reporting period and the movement in the index during the current and previous reporting period.

Chapter 24

Borrowing Costs

Overview

24.01 This chapter describes how an entity accounts for and discloses *borrowing costs*; that is, interest and other costs incurred in connection with debt financing activities. These costs may include interest expense on bank overdrafts and other borrowings, finance charges on lease obligations, and exchange differences on foreign currency borrowings to the extent that such differences are regarded as an adjustment to interest cost. An entity often use the terms "finance costs" or "interest expense" rather than the term "borrowing costs" in its financial statements.

24.02 An entity capitalizes borrowing costs directly associated with the acquisition, construction, or production of a qualifying asset, which, necessarily, takes a substantial amount of time to complete. An entity expenses all other borrowing costs in the period incurred, including borrowing costs incurred for assets ready for use or sale in a short period of time, or those already ready for use when acquired.

Summary of Selective Accounting Guidance

24.03 International Accounting Standard (IAS) 23, *Borrowing Costs*, is the primary accounting literature for guidance on how an entity accounts for and discloses borrowing costs.

Scope and Scope Exceptions

24.04 The scope of IAS 23 and this chapter relate to accounting for borrowing costs associated with debt financing and do not address the actual or imputed cost of equity, including the cost of preferred shares that has not been classified as a liability.

24.05 This chapter and the scope of IAS 23 also do not apply to the accounting treatment of borrowing costs directly attributed to the acquisition, construction, or production of the following:

- Qualifying assets measured at fair value, such as biological assets.
- Inventories that are manufactured or produced in large quantities on a repetitive basis. Refer to chapter 3, "Inventory," of this book for additional discussion regarding borrowing costs and inventories.

Recognition

24.06 An entity sometimes acquires, constructs, or produces assets that necessarily take a substantial amount of time to get ready for their intended use or sale. Such assets are called *qualifying assets*. IAS 23 requires an entity to capitalize as part of the cost of a qualifying asset all borrowing costs directly attributable to the asset's acquisition, construction, or production when it is probable that these costs will result in an inflow of future economic benefits from the asset's use or sale. The entity expenses all other borrowing costs in the period incurred. In addition, entities that apply IAS 29, *Financial Reporting in Hyperinflationary Economies*, should expense the part of borrowing costs that compensates for inflation during the same period.

24.07 An entity follows the following process when determining the amounts of borrowing costs to be capitalized and expensed during the period.

a. Determine the amount of borrowing costs eligible for capitalization.

i. When an entity borrows funds specifically to obtain a qualifying asset (for example, construction loan), capitalize the net borrowing costs on specific funds.

	Total amount of borrowing costs incurred from specific borrowings
–	(Investment income earned on temporarily invested funds)
=	Net borrowing costs on specific funds

ii. When the entity borrows funds specifically to obtain a particular qualifying asset (for example, construction of a building), the entity should be able to readily identify both the borrowing costs and their direct relationship to the asset. An entity sometimes temporarily invests borrowed funds until it must make a payment for the qualifying asset. In this case, the entity capitalizes only an amount equal to the actual borrowing costs incurred less the investment income earned on the invested funds during the period.

b. When an entity borrows funds more generally or through a centralized treasury function, capitalize borrowing costs to a qualifying asset by applying a capitalization rate to expenditures on that asset that exceed the amount of any specific borrowings.

i. The entity determines the appropriate capitalization rate as follows:

Compute the capitalization rate as the weighted average interest rate incurred on general borrowings during the period:

$$\text{Capitalization rate} = \frac{(\text{Total borrowing costs incurred} - \text{Cost of specific borrowings})}{(\text{Total borrowings} - \text{Specific borrowings})}$$

Sometimes it is appropriate for a parent entity to include all of its own borrowings and those of its subsidiaries in calculating a capitalization rate. However, subsidiaries should use only their own borrowings in this calculation.

ii. The entity determines the expenditures on the qualifying assets to date as only those expenditures that resulted in payments of cash, transfers of other assets, or the assumption of interest bearing liabilities less any progress payments or government grants received in connection with the asset. (Refer to chapter 12, "Accounting for Governmental Grants and Disclosure of Governmental Assistance," of this book and IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, for more guidance on such grants.)

The average carrying amount of the qualifying asset during a period, including previously capitalized borrowing costs, is a reasonable approximation of the expenditures to which the capitalization rate is applied in a particular period.

iii. Multiply the capitalization rate by the total expenditures on the qualifying asset to date less the amount of any specific borrowings on this asset.

	Total expenditures on qualifying asset to date
Less:	Amount of specific borrowings (if any)
	Excess expenditures over specific borrowings

Borrowing costs capitalized =
Capitalization rate × Excess expenditures over specific borrowings

c. Do not capitalize more than the total amount of borrowing costs incurred during the period.

Borrowing costs capitalized ≤ Total borrowing costs incurred

IAS 23 constrains the total amount the entity can capitalize as part of the cost of qualifying assets to no more than the total borrowing costs incurred during the period, whether from general or specific borrowings.

Initial Measurement

Commencement

24.08 An entity should begin capitalizing borrowing costs as part of the cost of a qualifying asset on the commencement date, in accordance with paragraph 17 of IAS 23. The commencement date for capitalization is the date when the entity first meets all of the following conditions:

- Incurs expenditures on the qualifying asset
- Incurs borrowing costs
- Begins activities necessary to get the qualifying asset ready for its intended use or sale

24.09 As noted previously, expenditures only include cash payments, asset transfers, and assumption of an interest-bearing liability related to the qualifying asset, less any progress payments or government grants received.

24.10 An entity may incur other costs necessary to the asset ready for use or sale that are not directly related to physical construction of the qualifying asset and may be incurred prior to the start of physical construction activities. Such costs include the cost to obtain permits to begin construction; design and other technical work; and administrative costs. When these costs meet the conditions for the start of the capitalization period and the entity has incurred borrowing costs, the entity will capitalize these borrowing costs, unless the entity has not undertaken any development or production activity necessary to get the asset ready for use. IAS 23 uses the example of land being developed for one of two purposes:

- An entity acquired land with a view to develop the land for resale and has undertaken activities related to that development, such as expenditures on landscaping design, drainage analysis, and location of roads. In this case, the entity should capitalize borrowing costs as part of the cost of the land from the date these expenditures began.
- An entity acquired land for the purpose of building a headquarters building and is holding the land without any associated development activity. In this case, the entity should not capitalize borrowing costs as part of the cost of the land.

Suspension

24.11 If the entity suspends the activities necessary to get a qualifying asset ready for use or sale for an extended period of time, it should also stop capitalizing borrowing costs until those activities resume. However, the entity would continue to capitalize borrowing costs during temporary delays that are necessary for certain assets, such as weather delays in construction activities.

Cessation

24.12 An entity should stop capitalizing borrowing costs when it has completed substantially all activities necessary to get the qualifying asset ready for its intended use or sale. An asset is generally ready for its intended use or sale when construction ends, regardless of the need to continue minor routine administrative work. Minor modifications, such as meeting customer specifications, do not prevent the entity from considering the qualifying asset substantially complete.

24.13 Sometimes the entity completes different parts of a qualifying asset at different times. A part may be capable of being used even when construction on other parts continues. In this case, the entity stops capitalizing borrowing costs when it completes substantially all of the activities necessary to get the qualifying asset ready for use or sale. For example, a steel manufacturer who is constructing a new industrial plant will incorporate several production processes that must occur in a particular sequence for the plant to operate. The steel manufacturer will stop capitalizing the borrowing costs associated with the industrial plant when substantially all of the activities necessary to operate the production sequence are complete.

Subsequent Measurement

24.14 When the carrying amount or the expected final cost of a qualifying asset exceeds its net realizable value (for inventory) or recoverable amount (for noncurrent assets), the entity should test the asset for impairment in accordance with IAS 2, *Inventories*, or IAS 36, *Impairment of Assets*, respectively. For example, in IAS 36, the carrying amount is written down or written off and, under certain circumstances, may be written back up.

Disclosure

24.15 Paragraph 26 of IAS 23 requires the entity to disclose the amount of borrowing costs capitalized during the period and the capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

24.16 See the following comprehensive example that shows the accounting for borrowing costs by a manufacturing company.

In July 2011, Anya Manufacturing Company began construction for a new manufacturing facility in Texas. To finance construction, company management decided that an additional construction loan was needed beyond the funds available from its previously planned borrowings. On July 1, when it began construction, Anya received the proceeds of a $500,000 construction loan with an interest rate of 5 percent. Anya kept the proceeds in an interest-bearing account at the bank, withdrawing funds only as needed during construction. During 2011, the invested funds earned $3,250.

Anya also had the following general borrowings on which it could rely if expenditures on the plant exceeded $500,000:

a. Anya had borrowed $100,000 from the bank on March 1, 2010, at an effective interest rate of 6.25 percent.

b. Anya had issued bonds at par on June 1, 2011. The bonds had a face value of $2,000,000 and a coupon rate of 4.38 percent.

Expenditures and activities to construct the facility began on July 1. Average expenditures during 2011 were $675,000.

Date		*Principal*	*Interest Rate*	*Annual Borrowing Costs*	*Fraction of Year Outstanding*	*Actual Borrowing Costs*
	Specific borrowing:					
7/1/2011	Construction loan	500,000	5.00%	25,000	0.75	18,750
	Investment income earned on temporary investment during 2011					3,250
	General borrowings:					
3/1/2010	Bank loan	100,000	6.25%	6,250	1.00	6,250
6/1/2011	Bonds	2,100,000	4.38%	91,980	0.67	61,320
	Total general borrowings	2,200,000				67,570
	Total borrowings	**2,700,000**				**86,320**
	Capitalization rate	=	$\frac{67,570}{2,200,000}$			
		=	**3.07%**			
7/1/2011	**Activities and expenditures start**					
	Average expenditures during 20X1		675,000			

Calculation of amount of borrowing costs to be capitalized and expensed during 2011:

		Eligible Borrowing Costs
Average expenditures during 2011	675,000	
Expenditures attributable to construction loan	500,000	15,500
Expenditures attributable to general borrowings	175,000	5,375
Total borrowing costs eligible for capitalization		20,875

Explanation: Because the amount of the construction loan exceeds the average expenditures in 2011, the company assumes it first used construction loan funds to cover expenditures; only after it had exhausted the funds from the construction loan did it use funds from general borrowings.

Eligible borrowing costs from construction loan =		
	Actual borrowing costs incurred	18,750
Less:	Investment income earned	(3,250)
	Borrowing costs eligible for capitalization	15,500

Eligible borrowing costs from general borrowings		
	Expenditures attributable to general borrowings	175,000
×	Capitalization rate	3.07%
	Borrowing costs eligible for capitalization	5,375

Capitalize the lower of total borrowing costs eligible for capitalization and actual borrowing costs during 2011:

A	Total borrowing costs eligible for capitalization	20,875
B	Actual borrowing costs in 20X10	86,320
	Capitalize (A<B)	**20,875**
	Expense	**65,445**

Chapter 25

Related Party Disclosures

Overview

25.01 An entity has relationships with related parties, such as its subsidiaries, associates, joint ventures, management, and equity owners. These relationships are a normal part of business activities. The entity may also engage in transactions and have outstanding balances, including commitments, with related parties that have the possibility of affecting its financial position, financial performance, and cash flows. In order to draw attention to these possibilities, it is important that the entity make users of an entity's financial statements aware of the existence of related parties and any transactions and outstanding balances through disclosure.

Summary of Selective Accounting Guidance

25.02 International Accounting Standard (IAS) 24, *Related Party Disclosures*, is the primary accounting literature applied in identifying related party relationships and any associated transactions, outstanding balances, and commitments; the circumstances in which an entity should disclose these facts; and the disclosures it should make about these items.

25.03 Other International Financial Reporting Standards (IFRSs) require other types of related party disclosures, but these requirements are in addition to the disclosure requirements described in IAS 24. These standards include IAS 1, *Presentation of Financial Statements*; IAS 19, *Employee Benefits*; IFRS 10, *Consolidated Financial Statements*; IFRS 12, *Disclosure of Interests in Other Entities*; and IAS 28, *Investments in Associates*. Refer to the guidance in chapter 2, "The Conceptual Framework and Financial Statement Presentation," chapter 34, "Employee Benefits," chapter 29, "Consolidated and Separate Financial Statements," and chapter 8, "Investments in Associates and Joint Arrangements," respectively, in this book for guidance on the disclosures required by these standards.

Scope

25.04 An entity should apply the guidance in IAS 24 when it

- identifies related party relationships and transactions.
- identifies outstanding balances, including commitments, between an entity and its related parties.
- identifies the circumstances in which the entity should disclose the items described in the previous bullet points.
- determines what information the entity should disclose.

25.05 IAS 24 requires disclosure of related party relationships, transactions, and outstanding balances and commitments, in the consolidated and separate financial statements of a parent or investor in accordance with IFRS 10. IAS 24 also applies to individual financial statements.

25.06 An entity discloses related party transactions and outstanding balances with other entities in a consolidated entity (group) in the entity's financial statements. The entity eliminates intragroup related-party transactions and outstanding balances in the process of preparing consolidated financial statements.

Related Parties

25.07 Paragraph 9 of IAS 24 defines a *related party* as a person or entity that is related to the entity preparing its financial statements; that is, the reporting entity. IAS 24 identifies the following related parties:

a. A person or a close member of that person's family is related to a reporting entity if that person

  i. has control, or joint control over the reporting entity;

  ii. has significant influence over the reporting entity; or

  iii. is a member of the key management personnel of the reporting entity or a parent of the reporting entity.

b. An entity is related to a reporting entity if any of the following conditions apply:

  i. The entity and the reporting entity are members of the same group (each parent, subsidiary, and fellow subsidiary is related to the others).

  ii. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

  iii. Both entities are joint ventures of the same third party.

  iv. One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

  v. The entity is a postemployment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity (if the reporting entity is a postemployment benefit plan, the sponsoring employers are also related to the reporting entity).

  vi. The entity is controlled or jointly controlled by a person identified in (*a*).

  vii. A person identified in (*a*)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

25.08 A close member of a related party's family is also a related party. Such family members may be influenced by or expected to influence the related party in dealings with the entity. Close family members include a person's children, spouse and spouse's children, or domestic partner and domestic partner's children, and dependents of the person, spouse, or domestic partner.

25.09 Associates and joint ventures of an entity are related parties as defined in IAS 24. Therefore, the subsidiaries of an entity's associates and joint ventures are also related parties of the entity.

25.10 IAS 24 defines a *related party transaction* as the transfer of resources, services, or obligations between a reporting entity and a related party, regardless of whether a price is charged. An example of a related party transaction includes the frequent activities an entity has with its subsidiaries, associates, and joint ventures. Under these circumstances, the entity has the ability to affect the financial and operating policies of these investees through the presence of control, significant influence, or joint control, respectively.

25.11 Related party relationships can affect an entity's profit or loss and financial position. An entity may enter into transactions with related parties that it would not otherwise enter into had the parties been unrelated. In addition, an entity may not enter transactions with related parties at the same amounts as the same transactions with unrelated parties. For example, an entity may sell goods to its parent at an internally developed transfer price instead of at the sales price and offering terms it provides to unrelated customers.

25.12 Even if there are no related party transactions, the existence of the related party relationship may be enough to affect the transactions the entity has with other unrelated parties. For example, a parent may acquire a trading partner of one of its subsidiaries when the trading partner is engaged in the same activities as the subsidiary.

25.13 The following are not related parties in the context of paragraph 11 of IAS 24:

- Two entities only because they have a director or other key member of management personnel in common.
- A key management member of one entity has significant influence over another entity.
- Two joint venturers only because they share joint control over a separate joint venture.
- Customers, suppliers, franchisors, and distributors that transact a significant volume of business, simply by virtue of the resulting dependence.

25.14 Providers of financing, trade unions, public utilities, and departments and agencies of a government that do not control, jointly control, or significantly influence the reporting entity are not related parties simply by virtue of their normal dealings with an entity, even though they may affect the entity's freedom of action or participate in its decision-making process.

25.15 Types of transactions that would require disclosure if they are made with a related party include the following:

- Purchase or sale of finished or unfinished goods, property, or other assets
- Receiving or providing services
- Leases
- Transfers of research and development
- Transfers under license agreements and finance arrangements, including loans and equity contributions in cash or in kind
- Providing guarantees or collateral
- Commitments to do something if a particular event occurs or does not occur in the future, including recognized and unrecognized executory contracts
- Settling liabilities on behalf of the other entity or by the entity of that related party
- Participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities (refer to paragraph 42 of IAS 19 for additional guidance)
- Services in connection with the acquisition of raw materials for processing or manufacturing by related parties
- Payment of commissions from and to other related parties
- Profit-sharing arrangements among the related parties

25.16 The definitions of a related party, a related party transaction, and other terms contained in this guidance should be closely assessed by an entity when determining the type of required information and relationships to disclose in its financial statements.

Disclosure

All Entities

25.17 An entity should disclose its transactions and relationships with related parties to users of the financial statements to enable them to form a view about the possible effects the presence these parties may have on its financial position, financial performance, and operating policies. Paragraphs 13–27 of IAS 24 require disclosures for a variety of circumstances, levels of detail, relationships, and transactions.

25.18 In addition to disclosures required by IAS 27 and IFRS 12, an entity should disclose the relationships between a parent and its subsidiaries, whether or not there are transactions between them. An entity should disclose the name of the entity's parent and, if different, the ultimate controlling party. If neither the entity's immediate parent nor the ultimate controlling party produces consolidated financial statements for public use, the entity should disclose the name of the next most senior parent (the first parent in the group above the immediate parent) that produces consolidated financial statements available for public use.

25.19 An entity should disclose the total compensation of its key management personnel for each of the following categories:

- Short-term employee benefits
- Postemployment benefits
- Other long-term benefits
- Termination benefits
- Share-based payments

25.20 If related party transactions occurred during the period covered by an entity's financial statements, the entity should disclose the nature of the related party relationship along with information about those transactions and outstanding balances, including commitments. In addition, along with the disclosures in paragraph 25.19, an entity, at a minimum, should disclose the following information:

- Amount of the transactions
- Amount of any outstanding balances, including commitments, and their terms and conditions, whether they are secured, the nature of the consideration to be provided in settlement, and the details of any guarantees received or given
- Provisions for doubtful debt related to the amount of outstanding balances
- Expense recognized during the period related to the estimated uncollectible accounts due from related parties

25.21 An entity should make the related party transactions disclosure, described in paragraph 25.20, separately for each of the following categories:

- Parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint ventures in which the entity is a joint venturer
- Key management personnel of the entity or its parent
- Other related parties

25.22 Disclosure of amounts payable to, and received from, the related parties, separated by category, is an extension of the disclosure requirements in IAS 1. An entity should provide these disclosures, either in the statement of financial position or in the notes, to provide a more comprehensive analysis of related party balances and transactions.

25.23 An entity may aggregate similar related party transactions unless separate disclosure is necessary for understanding a transaction and its effect on the entity's financial statements.

25.24 When the terms of a related party transaction are equivalent to the terms in arm's length transactions, the entity discloses those terms only if it can substantiate those terms.

Government-Related Entities

25.25 A reporting entity is exempt from the disclosure requirements of paragraph 25.20 when it has related party transactions and outstanding balances, including commitments with the following entities:

- A government that has control, joint control, or significant influence over the reporting entity
- Another entity that is a related party because the same government has control, joint control, or significant influence over both the reporting entity and the other entity

25.26 When an entity applies the exemption described in the previous paragraph, it should disclose the following information about the transactions and related outstanding balances with these governmental entities:

- The government's name and the nature of the relationship it has with the reporting entity, such as the type of control, joint control, or significant influence it has over the reporting entity
- The following information in sufficient detail in order to enable financial statement users to understand the effects of the related party transactions on the entity's financial statements:
  - Nature and amount of each individually significant transaction
  - For other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent (these types of transactions are described in paragraph 21 of IAS 24)

25.27 When complying with the disclosures requirements described in paragraph 25.26, an entity needs to use its judgment in determining the level of detail it provides in these disclosures. The entity should consider the closeness of the related party relationships and other factors relevant in establishing the level of significance of the transaction, such as whether the transaction is

- of significant size,
- carried out on nonmarket terms,
- outside normal day-to-day business operations, such as the purchase and sale of a business,
- disclosed to regulatory or supervisory authorities,
- reported to senior management, or
- subject to shareholder approval.

Chapter 26

Events After the Reporting Period

Overview

26.01 Some events that occur after the date the reporting period ends may provide evidence about conditions that existed at that date, whereas other events are only indicative of conditions that arose after that date.

26.02 This chapter discusses when an entity should adjust its financial statements for events occurring after the end of a reporting period and when no adjustments should be made. This chapter also explains the disclosures an entity should provide about the date when the financial statements were authorized for issue and about events after the reporting period.

26.03 International Financial Reporting Standards (IFRSs) are based on the assumption that the entity is a going concern. When events after the reporting period indicate that a going concern assumption is not appropriate, an entity should not prepare its financial statements on that basis.

Summary of Selected Accounting Guidance

26.04 International Accounting Standards (IAS) 10, *Events After the Reporting Period*, is the primary accounting literature for guidance about how an entity accounts for and discloses events that occur after the reporting period. Refer to chapter 30, "Accounting Policies, Changes in Accounting Estimates, and Errors," of this book for guidance about correcting errors that are discovered in the current period, before the financial statements are authorized or issued, and for material errors that are discovered in a subsequent period.

Scope

26.05 This chapter and IAS 10 apply to the accounting for and disclosure of events after the reporting period and before the date the financial statements are authorized for issuance.

26.06 The scope of IAS 10 and this chapter also applies when events after the reporting period indicate it is not appropriate for an entity to prepare its financial statements on a going concern basis.

Recognition and Measurement

26.07 IAS 10 defines *events after the reporting period* as those events, whether favorable or unfavorable, that occur between the end of the reporting period and the date the financial statements are authorized for issuance. The following are the two types of such events:

- *Adjusting events*: Events that provide evidence of conditions existing at the end of the reporting period.
- *Nonadjusting events*: Events that provide evident of conditions that arose after the end of the reporting period.

Adjusting Events

26.08 IAS 10 requires an entity to adjust the amounts recognized in its financial statements for adjusting events. Adjusting amounts recognized in the financial statements can include changing the measurement of recognized events, recognizing any measurement events that were not previously recognized, or derecognizing events that were previously recognized. Examples of adjusting events that occur after the end of the reporting period include the following:

- Settlement of a court case that was pending at the end of the reporting period that confirms the existence of an obligation at the end of the reporting period. At the end of the reporting period, the entity understood that there was a possibility an obligation existed at that date. Settlement provides the necessary evidence that the obligation existed. Either the entity had recognized a contingent liability for the expected outcome of the litigation or it had not. If the entity had already recognized a contingent liability, it adjusts the amounts recognized as a liability and expense to the known amount. If no contingent liability was recognized, the entity adjusts its financial statements to recognize a liability and expense for the known amount.

- Receiving information after the reporting period that indicates an asset was impaired at the end of the reporting period. Such information may include the following:
  - Subsequent sales of inventory that provide evidence about net realizable value at the end of the reporting period. Refer to IAS 2, *Inventories*, and chapter 3, "Inventory," of this book for additional guidance, examples, and disclosures with respect to inventory write-downs.
  - A customer files for bankruptcy after the reporting period. Bankruptcy filings usually confirm that a loss existed at the end of the reporting period and provide evidence that the carrying amount of the customer's trade receivable is overstated.
- Finalization of the actual amount of the price of an asset purchase or proceeds of an asset sale that had been recorded at an estimated amount at the reporting date.
- Finalization of the amount of profit-sharing or bonus payments when the entity had a present legal or constructive obligation at the reporting date to make payments under agreements existing at that date. For example, if the entity is obligated to make payments to some employees based on reported net income at the reporting date and it does not determine reported net income until after the balance sheet date, the entity should adjust the estimated amounts included in the financial statements to the adjusted amounts.
- Discovery of fraud or errors that show that the financial statements are incorrect. Refer also to IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, and chapter 30 of this book for additional guidance, examples, and disclosures.

26.09 See the following example of an adjusting event that occurs after the reporting date.

A major customer of a clothing manufacturer files for bankruptcy protection after the manufacturer's reporting period but before the financial statements are authorized for issue. It is likely that the customer's bankruptcy was caused by poor credit condition that existed over at least some part of the previous year. Therefore, the bankruptcy filing represents evidence that the condition existed on or before the end of the manufacturer's reporting period. The manufacturer should write-down the customer receivable to the amount it expects to collect (possibly, zero) and review its estimate of uncollectible accounts.

Nonadjusting Events

26.10 An entity should not adjust its financial statements to reflect events that occurred after the reporting period if there is no evidence to suggest that the conditions that caused the event existed on or before the reporting period. However, when the effects of a nonadjusting event are material to the financial statements, the entity should disclose the information about the event as required by paragraph 21 of IAS 10. Examples of nonadjusting events that generally require disclosure are the following:

- Significant decline in the fair value of investments due to a change in market conditions that occurred subsequent to the reporting period
- Major business combination after the reporting period or disposal of a major subsidiary (refer to the IFRS 3, *Business Combinations*, and chapter 16, "Business Combinations," of this book for additional guidance, examples, and required disclosures)
- Fire after the reporting period that destroys a major production plant
- Implementation or announcement of a major restructuring (refer to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and chapter 28, "Provisions, Contingent Liabilities, and Contingent Assets," of this book for additional guidance, examples, and required disclosures)
- Abnormally large changes in asset prices or foreign exchange rates

- Changes in tax rates or laws that have been announced or enacted after the reporting period that have a significant effect on current and deferred tax assets and liabilities (refer to IAS 12, *Income Taxes*, and chapter 10, "Income Taxes," of this book for additional guidance, examples, and required disclosures)
- Significant commitments or contingent liabilities, such as a major litigation solely based on events occurring after the reporting period

26.11 See the following example of a nonadjusting event that occurs after the reporting date.

A clothing manufacturer has a reporting period ending December 31, 2011. On March 14, 2012, the board of directors authorized the financial statements for issue. On February 28, 2012, the clothing manufacturer suffers a major casualty loss when an earthquake destroys one of its three inventory warehouses.

Because the fire occurred after December 31 and did not reflect conditions existing on December 31, the manufacturer would not adjust the carrying amounts of either inventory or the warehouse building in the 2011 financial statements to reflect the losses from the fire. However, the clothing manufacturer would disclose the fact that a fire destroyed a building containing inventory items. If possible, it should disclose an estimate of the financial impact of the losses users would expect to see in its next set of financial statements.

Dividends

26.12 When dividends are declared after the reporting period but before the financial statements are authorized for issue, the entity does not recognize a liability for the declaration at the end of the previous reporting period. No obligation existed at the reporting date. The entity discloses the fact that a dividend was declared in the notes to the financial statements in accordance with IAS 1, *Presentation of Financial Statements*.

Going Concern

26.13 If management determines after the end of the reporting period that it intends, or had no realistic alternative, to liquidate the entity or cease trading, the entity should not prepare its financial statements on a going concern basis.

26.14 When the going concern assumption is no longer appropriate, IAS 10 requires the entity to make a fundamental change in its basis of accounting, rather than adjust the amounts recognized on the original basis. Among other required disclosures, IAS 1 requires the entity to disclose that it did not prepare the financial statements on a going concern basis.

Disclosures

Date of Authorization for Issue

26.15 The process of authorizing financial statements varies depending upon statutory requirements, management structure, and the entity's procedures for finalizing the financial statements. The entity includes in its financial statements the events that occur from the date of the end of reporting period through the date when the financial statements are authorized for issue. An entity should disclose in the financial statements the following information about the authorization for issue:

- Date the financial statements were authorized for issue
- Who authorized the financial statements for issue
- Whether owners or others have the power to amend the financial statements after issuance

26.16 Sometimes an entity is required to submit the financial statements that management or the board of directors authorized for issue to either shareholders or a nonexecutive supervisory board for final approval. In either case, IAS 10 states that the financial statements are authorized for issue when management or the board authorizes them, not the date of approval by shareholders or others.

26.17 See the following example that illustrates the process of the issuance of financial statements.

> A chemical manufacturer completed its draft financial statements as of and for the year ending December 31, 2011, and is required to file its financial statements with a regulatory body on or before June 1, 2012.
>
> The following chronological fact pattern in 2012 illustrates the date that the financial statements are authorized for issue:
>
> - February 28: Management completed and finalized the financial statements.
> - March 14: The board of directors reviewed the financial statements and authorized them for issue.
> - March 21: Management submitted and received approval of the financial statements from a nonexecutive supervisory board.
> - March 22: Management announced earnings and other selected financial information.
> - April 1: Management made the financial statements available to shareholders and others.
> - May 12: Shareholders approved the financial statements.
> - May 15: Management filed the financial statements with its regulator.

26.18 For purposes of assessing events after the end of the reporting period, March 14 is the date that the financial statements are authorized for issue. Neither the date the supervisory board nor the date shareholders approved the financial statements are relevant when determining whether an event would require adjusting the financial statements or additional disclosure. Information about events that occur after March 14 would not be reflected in the December 31, 2011, financial statements.

Updating Disclosures About Conditions at the End of the Reporting Period

26.19 When the entity receives new information about conditions existing at the end of the reporting period, it should update disclosure information about those conditions.

Nonadjusting Events

26.20 If there is a material nonadjusting event after the reporting period, an entity should disclose the following information for each material category of nonadjusting event:

- Nature of the event
- Estimate of the event's financial effect or a statement that the entity cannot make an estimate

Chapter 27

Transfers of Assets From Customers

Overview

27.01 This chapter describes how an entity accounts for a transfer from its customers of one of the following items that the entity must use to connect the customer to a network, provide the customer with ongoing access to a supply of goods or services, or both:

- Property, plant, and equipment (PP&E)
- Cash that may only be used to construct items of PP&E

Summary of Selected Accounting Guidance

27.02 International Financial Reporting Interpretations Committee (IFRIC) 18, *Transfers of Assets from Customers*, is the primary accounting guidance for the transfer of items of PP&E from customers to the entity for the purposes described previously.

Scope and Scope Exceptions

27.03 This chapter and IFRIC 18 apply to the following types of agreements that an entity may have with its customers:

- The customer will transfer the following to the entity:
  - Item(s) of PP&E
  - Cash to construct or acquire item(s) of PP&E
- The entity will use the items of PP&E that have been transferred, constructed, or acquired to do either or both of the following:
  - Connect the customer to a network
  - Provide the customer with ongoing access to a supply of goods

27.04 The following are examples of agreements that may fall within the scope of IFRIC 18:

- A public utility receives cash from a customer that it uses to construct the infrastructure necessary to connect that customer to a supply of electricity, gas, or water.
- A customer may outsource its existing information technology function to an external provider and consequently transfer all of its existing information technology PP&E to the provider.

27.05 IFRIC 18 does not apply to either the following, which are within the scope of other International Financial Reporting Standards:

- Agreements in which the transfer is a government grant. Guidance regarding government grants, as defined in International Accounting Standards (IAS) 20, *Accounting for Government Grants and Disclosure of Government Assistance*, are described in chapter 12, "Accounting for Governmental Grants and Disclosure of Governmental Assistance," of this book.
- Agreements in which a service concession arrangement is within the scope of IFRIC 12, *Service Concession Arrangements*, involving the use of an infrastructure. Refer to chapter 21, "Service Concession Arrangements," of this book for guidance regarding service concession arrangements.

Recognition

27.06 When a customer transfers an item of PP&E to an entity for the purpose addressed by this chapter and IFRIC 18, the entity should assess whether the item transferred meets the definition of an asset, as defined in paragraph 49(a) in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*; that is,

- the item is a resource controlled by the entity.
- the item results from past events.
- future economic benefits will flow to the entity from the item.

27.07 When the entity assesses whether the item meets the definition of an asset, it is not essential that the entity owns—only that the entity controls—the item of PP&E. In fact, even when the entity obtains ownership of the transferred item, if a customer continues to control the transferred item, the item does not meet the definition of an asset.

27.08 Generally, the entity that controls an asset can do as it pleases with that asset. For example, when an entity controls an asset, it can

a. exchange that asset for other assets,

b. employ the asset to produce goods or services,

c. charge a price for others to use the asset, and

d. use the asset to settle liabilities, hold it, or distribute it to owners.

27.09 When assessing whether it has control of a transferred item of PP&E, the entity should take into consideration all relevant facts and circumstances. For example, an entity may normally conclude that it controls the transferred item because it has the ability to decide how to operate and maintain the PP&E used to provide the goods, services, or network connection to the customer and when to replace it.

Initial Recognition and Measurement

27.10 The entity recognizes a transferred, acquired, or constructed item of PP&E that meets the definition of an asset in accordance with paragraph 7 of IAS 16, *Property, Plant and Equipment*, when the following recognition criteria are met:

- It is probable that the future economic benefits associated with the item will flow to the entity.
- The entity can measure the cost of the item reliably.

27.11 The entity measures the cost of the item of PP&E as its fair value in accordance with paragraph 24 of IAS 16. Refer to chapter 5, "Property, Plant, and Equipment," of this book for guidance in determining the measurement of PP&E.

27.12 Agreements within the scope of IFRIC 18 are considered transfers of dissimilar goods and services. Therefore, when an entity recognizes and measures the item of PP&E in accordance with IFRIC 18, it will recognize revenue on the transaction in accordance with paragraph 12 in IAS 18, *Revenue*.

Separately Identified Services

27.13 An entity may agree to deliver one or more separately identifiable goods or services to the customer in exchange for the transferred PP&E. For example, an entity may agree to connect the customer to a network, provide the customer with ongoing access to a supply of goods or services, or both. The entity should recognize revenue for each of the separately identifiable goods or services when those goods or services are provided to the customer in accordance with paragraph 13 of IAS 18.

27.14 Paragraph 15 of IFRIC 18 provides the following examples of features that indicate a separately identifiable service in an entity's agreement with a customer:

- The entity delivers a service connection to the customer that has a reliable fair value and represents stand-alone value to that customer.

- The entity delivers ongoing access to a supply of goods or services to the customer over the period covered by the agreement at a price that is lower than it would charge without the transfer of the item of PP&E.

27.15 In contrast, if the customer transferring PP&E to the entity pays the same price for ongoing access to a supply of goods or services that other customers pay, it is likely that ongoing access to the supply of goods or services is outside the entity's agreement for the transfer of PP&E.

Revenue Recognition

27.16 When an agreement and a transfer of assets from customers is within the scope of IFRIC 18, an entity should recognize revenue as follows:

- The entity provides only one service to the customer: Recognize revenue in accordance with paragraph 20 of IAS 18 when the service is performed.
- The entity provides more than one separately identifiable service: Recognize revenue in accordance with paragraph 13 of IAS 18, as follows:
  - Allocate the fair value of the total consideration received or receivable for the agreement to each service.
  - Recognize revenue for each service by applying recognition criteria in IAS 18 separately to each service.

27.17 When part of the entity's agreement with the customer is to provide ongoing services, the entity generally determines the period over which it recognizes revenue by reference to the terms of the agreement. If the agreement does not specify a period, the entity should recognize revenue over a period that is no longer than the useful life of the transferred asset that it uses to provide the ongoing service.

Transfer of Cash

27.18 When an entity receives a transfer of cash from a customer, it assesses whether its agreement is within the scope of IFRIC 18 and whether the item of PP&E acquired or constructed meets the definition of an asset and the relevant recognition criteria. The entity measures the cost of the item of PP&E in accordance with the guidance in IAS 16. Finally, the entity recognizes revenue in accordance with paragraphs 13–20 of IFRIC 18 and the guidance in this chapter at the amount of cash received from the customer.

27.19 Refer to the illustrative examples in IFRIC 18 that accompany, but are not part of, the interpretation.

Chapter 28

Provisions, Contingent Liabilities, and Contingent Assets

Overview

28.01 This chapter provides guidance on the accounting treatment of provisions, contingent liabilities, and contingent assets, and the required disclosures in an entity's financial statements that will enable users to understand their nature, timing, and amount.

28.02 Events occur that may result in the creation of a legal or constructive obligation for an entity and it will have no realistic alternative but to settle that obligation. Sometimes these obligating events occur because an entity enters into a legally-binding contract by an act of governmental legislation or other operation of law. Other times, obligations may occur based upon an entity's voluntary actions, such as publishing its business policies, or establishing an industry practice. These events may create constructive obligations because the parties affected, such as customers or employees who rely on these policies or actions, have valid expectations that the entity will accept its responsibilities.

28.03 When an obligation meets the definition of a liability in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting* (conceptual framework), an entity should recognize and measure a liability when it is probable that settlement will result in an outflow of resources, and the entity can measure the liability reliably in accordance with the measurement requirements of the relevant International Financial Reporting Standard (IFRS). If there is uncertainty about the amount or timing of the cash flows to settle the liability, an entity would recognize a provision (that is, a liability of uncertain timing and amount).

28.04 Additionally, an entity should consider those obligations that are not present obligations because they are unconfirmed, or do not meet the criteria for liability recognition. Such obligations are referred to as contingent liabilities, and the entity may be required to disclose information about them.

28.05 Finally, this chapter also addresses the accounting treatment and disclosure of contingent assets, a potential resource whose existence is unconfirmed or does not meet the asset recognition criteria in the conceptual framework.

28.06 This chapter describes the accounting, recognition, measurement, and disclosure guidance for contingencies, unless addressed elsewhere in IFRSs and explains how to apply these requirements to specific provisions, such as future operating losses, onerous contracts, and restructurings.

Summary of Selective Accounting Guidance

28.07 The primary accounting literature that relates to the accounting and disclosure of provisions, contingent liabilities, and contingent assets is International Accounting Standard (IAS) 37, *Provisions, Contingent Liabilities and Contingent Assets*, unless a particular liability is covered elsewhere in IFRSs (described further in the scope section of this chapter). For certain liabilities associated with waste and electrical and electronic equipment, International Financial Reporting Interpretations Committee (IFRIC) 6, *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*, applies. The authoritative guidance for the classification of provisions, contingent liabilities, and contingent assets is found in IAS 1, *Presentation of Financial Statements*, except for those specific classifications included in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

Scope and Scope Exceptions

28.08 This chapter and the scope of IAS 37 apply to the accounting for all provisions, contingent liabilities, and contingent assets for all entities, unless specifically excluded. Provisions for restructuring, including restructuring costs associated with discontinued operations, are within the scope of IAS 37 and this chapter. IFRS 5 may require additional disclosures about restructurings.

28.09 IAS 37 does not apply to the accounting for provisions, contingent liabilities, and contingent assets of the following:

- Executory contracts, other than onerous contracts within the scope of IAS 37. *Executory contracts* are contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to the same extent.
- Financial instruments, including guarantees, accounted for in accordance with the guidance of IAS 39, *Financial Instruments: Recognition and Measurement*.[1] Refer to chapter 17, "Financial Instruments," of this book for additional guidance regarding financial instruments.
- The following items addressed in other standards:
  - Income taxes. Refer to chapter 10, "Income Taxes," of this book for a detailed discussion on income taxes as well as IAS 12, *Income Taxes*.
  - Employee benefits. Refer to IAS 19, *Employee Benefits*, and chapter 34, "Employee Benefits," of this book for a detailed discussion.
  - Leases, unless the operating lease has become onerous, in which case IAS 37 will apply. Refer to chapter 7, "Leases," of this book for a detailed discussion regarding IAS 17, *Leases*.
  - Insurance contracts, providing there are provisions, contingent assets, or liabilities arising from contractual obligations and rights under insurance contracts within the scope of IFRS 4, *Insurance Contracts*. These rights and contractual obligations for insurance contracts apply the guidance in IFRS 4. Provisions, contingent assets, or liabilities that do not arise from contractual obligations and rights are included in the scope of IAS 37.
  - Construction contracts.

28.10 IAS 37 does not address revenue recognition arising from the treatment of some provisions, such as receiving a fee for providing a guarantee. Revenue recognition under these circumstances is addressed in IAS 18, *Revenue*. The guidance in IAS 37 for these provisions does not change the requirements in IAS 18.

28.11 IAS 37 does not prohibit nor require capitalization of costs resulting from recognition of a provision. Neither this chapter nor IAS 37 address the treatment of expenditures as assets or expenses, but specific guidance may exist in other IFRSs.

28.12 *Provisions* are defined as liabilities of uncertain timing or amount. In some jurisdictions, the term "provision" is used to describe a valuation allowance, such as allowance for doubtful accounts, or accumulated depreciation or accumulated impairment loss accounts, that adjust the carrying amount of an asset. Valuation allowances are not included in the definition of provisions described in this chapter and, therefore, neither IAS 37 nor this chapter address their use.

Recognition

Provisions

28.13 An entity recognizes a provision when an entity has a present legal or constructive obligation that meets the definition of a liability and the recognition criteria described previously in this chapter and in the conceptual framework. Except in limited circumstances (refer to chapter 16, "Business Combinations," of this book), an entity should not recognize a provision unless these criteria are met.

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[1] International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, was issued in November 2009 and again in October 2010 and is effective for annual periods beginning on or after January 1, 2015. Upon effective date, the reference within International Accounting Standard (IAS) 37, *Provisions, Contingent Liabilities and Contingent Assets*, to IAS 39, *Financial Instruments: Recognition and Measurement*, will be replaced with IFRS 9.

28.14 Provisions are different from other liabilities, such as trade payables and other accruals, because uncertainty surrounds either the amount of the required future expenditure, the timing of settlement, or both. Although it is sometimes necessary to estimate the amount of an accrual, that uncertainty is generally less than that for a provision.

28.15 IAS 37 makes a distinction between provisions and contingent liabilities. Contingent liabilities are not recognized as liabilities because they are possible, not present obligations yet to be confirmed by a future event, or they are present obligations that do not meet probability or measurement reliability criteria necessary for liability recognition.

28.16 An entity recognizes the cost of decommissioning, environmental remediation and similar liabilities in accordance with IAS 37 and includes this cost in the carrying value of the related asset. In accordance with paragraph 9 of IFRIC 6, a liability for waste management costs for historical household equipment does not arise as products are manufactured or sold, because the obligation is linked to participation during the measurement period. Thus, no obligation exists, unless or until the entity has a market share during its measurement period.

Present Obligations

28.17 An entity recognizes a provision when it has a present obligation that results from a past transaction or event. Generally, it is clear when a past event gives rise to a present obligation. In rare circumstances, an entity may not be able to determine if a present obligation exists. In this case, the entity should take into account all of the evidence available to determine whether it is more likely than not that a present obligation exists at the end of the reporting period. For example, when an entity is involved in a lawsuit and there is a dispute concerning the occurrence of certain events, the entity may obtain an expert opinion as evidence that may provide a basis for determining if it is probable (more likely than not) that it has a present obligation. If a liability is not recognized, the entity should disclose information about the contingent liability at the end of the reporting period, unless there is only a remote possibility of an outflow of resources.

Past Events

28.18 Other than in rare cases, a past event that leads to a present obligation is an obligating event. Obligating events in which the entity has no realistic alternative to settlement may be legal obligations whose settlement is enforceable by law, or constructive obligations caused by an event or action by the entity that has created a reasonable expectation in the affected parties that the entity will fulfill its responsibilities (promises).

28.19 Examples of obligations that result from past events, which exist independent of an entity's future actions, include the following:

- Clean-up costs and penalties associated with unlawful environmental damage, which would lead to a future outflow of an entity's resources, regardless of any future actions.
- The decommissioning costs of a nuclear power station, providing there is an obligation to remedy damages caused, unless a future action can avoid these future expenditures (for example changing a method of operation). For additional information regarding decommissioning and restoration, refer to chapter 5, "Property, Plant, and Equipment," of this book.

28.20 Although an obligation is always owed to another party, it is not necessary for the entity to know that party's identity. Constructive obligations that result from an event or action by the entity that created a reasonable expectation in affected parties that the entity will fulfill its responsibilities to them, are based upon a decision by an entity's board or management and communicated to affected parties before the end of the reporting period.

28.21 An event that does not give rise immediately to an obligation may do so at a later date. For example, an entity's business activities may have polluted a plant site before any laws requiring environmental remediation were passed. At that date, the entity had no obligation to clear up the plant site. However, if a new law required the entity to remediate the site, or it issued a policy statement that it would remediate at the site, it would recognize a provision for the costs of remediation for its legal or constructive obligation, respectively, at the date the law was enacted or it made the policy statement.

Probable Outflow of Resources That Embody Economic Benefits

28.22 For recognition of a present obligation to occur, it must be probable that the entity will settle the obligation with outflows of resources that embody economic benefits. For the purposes of IAS 37, the term *probable* is defined as “more likely than not;” that is, the entity recognizes a provision when it is more likely than not that an outflow of economic resources will occur. If the probability criteria are not met, an entity should disclose a contingent liability, unless there is only a remote possibility of an outflow of resources.

28.23 An entity considers similar obligations, such as product warranties and other similar contract types, as a whole when assessing probability of settlement. Even if there is a likelihood that only a small outflow may result, it may be probable that some outflow of resources to settle the obligations as a whole will occur. Under these circumstances, an entity should recognize a provision, provided that other recognition criteria in IAS 37 are met.

Reliable Estimate of the Obligation

28.24 An entity may use estimates when determining the amount of an obligation, when the estimates are reliable. Due to their nature, provisions are more uncertain than other items in the statement of financial position, but the use of estimates for provisions and other items is an essential part of financial statement preparation as long as estimation does not undermine the reliability of the statements. Generally, an entity can determine a range of possible outcomes when estimating an obligation, which permits recognition of a reasonable and reliable liability. In rare circumstances, when an entity cannot make a reliable estimate of its obligation, a liability is not recognized. Instead, this provision is disclosed as a contingent liability.

Contingent Liabilities

28.25 An entity does not recognize contingent liabilities, but discloses information about them in the notes, unless there is only a remote possibility of an outflow of the entity’s economic resources.

28.26 When an entity is jointly and severally liable for an obligation, it treats the portion of the obligation that another party is expected to meet as a contingent liability. It recognizes the portion it expects to meet as a provision, as long as the other recognition criteria in IAS 37 are met, except in the rare case that no reliable estimate can be made.

28.27 An entity should continually assess its contingent liabilities to determine whether an outflow of resources has become probable. If so, the entity should recognize a provision in the financial statements in the period the contingency becomes probable, unless no reliable estimate can be made.

Contingent Assets

28.28 Unplanned or unexpected events may give rise to the possibility of an entity receiving an inflow of economic benefits, known as a contingent asset. An entity might consider its likelihood of winning a lawsuit to be a contingent asset, even though the outcome of the trial is uncertain.

28.29 Contingent assets may never be realized and are not recognized as assets in an entity’s financial statements. If an inflow of economic benefits is probable, the entity should disclose information about them. However, if realization of income from the contingent asset is virtually certain, IAS 37 considers the asset to no longer be contingent and the entity should recognize the asset.

28.30 The following appendixes within IAS 37 provide additional insight on the topics discussed previously:

- Appendix A: This appendix provides three tables that will assist entities in determining present obligations, possible obligations, possible assets, and reimbursements when some or all of the expenditure required to settle the provision is expected to be reimbursed by another party.
- Appendix B: This appendix summarizes the main recognition requirements of IAS 37 in the form of a decision tree.

- Appendix C: This appendix provides several illustrative examples of present obligations as a result of a past obligating event.

28.31 Example 1 in appendix C of IAS 37 provides the following example of a manufacturer that provides warranties to their customers at the time of the sale of their products.

Example 28-1

Facts

- Under the terms of the contract for sale, the manufacturer represents that it will repair or replace its products for manufacturing defects that become apparent within three years from the date of the sale.
- Based on past experience, it is probable (more likely than not) that there will be some claims under the warranties and it will repair or replace products as a result.

Analysis

- There is a present obligation as a result of a past obligating event (the sale) because the sale of the product with a warranty gives rise to a legal obligation.
- It is probable that there will be an outflow of resources for the warranties as a whole, based on the manufacturer's experience.
- The manufacturer should recognize a provision for the best estimate of the costs of repairing or replacing products sold under the warranty before the end of the reporting period.

Measurement

28.32 An entity should recognize the best estimate of expenditures required to settle the present obligation as a provision at the end of the reporting period. The *best estimate* is defined as the amount an entity would expect to pay to settle or transfer the obligation to a third party at the end of the reporting period. An entity's management will use judgment in estimating the outcome and financial effects, and may use evidence from independent experts, similar transaction experience, and additional evidence and information gathered after the reporting period.

28.33 Uncertainties surrounding the amount to recognize as a provision are based on the circumstances of the uncertainty. When measuring large populations of items and estimating the weight of all possible outcomes adjusted by their associated probabilities, the entity determines expected value. This method is a statistical method of estimation and determines different outcomes based upon various probabilities. When there is a continuous range of possible outcomes, and each point in the range is as likely as the other, the entity uses the midpoint of the range.

28.34 If there is a single obligation, the most likely outcome may be the best estimate of the liability, but an entity should consider other possible outcomes. If those outcomes are mostly lower or higher than the most likely outcome, the best estimate will likely be a lower or a higher amount, respectively.

28.35 An entity measures a provision at a pretax amount. Any changes in tax consequences are addressed in accordance with IAS 12.

28.36 The following example describes how a manufacturer measures the warranty they provide when selling their goods to customers.

Example 28-2

Facts

- Under the terms of the sale, the manufacturer represents to its customers that it will cover the costs of repairing any manufacturing defects that become apparent within the first six months after purchase.
- The manufacturer estimates that if minor defects were detected in all of their products sold, repair costs of CU 1,000,000 would result.
- The manufacturer estimates that if major defects were detected in all of their products sold, repair costs of CU 4,000,000 would result.

- Based on past experience and future expectations, the manufacturer estimates for the coming year that 75 percent of its products will have no defects; 20 percent of its products will have minor defects; and 5 percent of its products sold will have major defects.

Analysis

Based on the preceding facts, the manufacturer would assess the probability of an outflow for the warranty obligation as a whole, as follows.

(75% × zero) + (20% × CU 1,000,000) + (5% × CU 4,000,000) = CU 400,000

Product	*Percent of Total Sales*	*Cost*	*Weighted Average Cost*
Products with no defects	75%	0	0
Products with minor defects	20%	1,000,000	200,000
Products with major defects	5%	4,000,000	200,000
Total			400,000

Risks and Uncertainties

28.37 It is highly likely that circumstances and events contain risks and uncertainties. These risks and uncertainties will need to be taken into account when determining a provision's best estimate. Risks are based on the variability of outcomes and an adjustment for risk may increase a liability amount. Caution is needed when judgment is used to assess uncertainties so that there is no misstatement of liabilities or expenses, which may result in a deliberate overstatement of liabilities or excessive provisions. Uncertainties regarding the amount of expenditures are disclosed in the notes to the financial statements.

Present Value

28.38 When measuring the amount of the provision, the entity should take into account the effect of the time value of money, if material, by determining the present value of the expenditures that are expected to be required to settle the obligation. The entity should use a pretax discount rate(s) that reflects risks specific to the liability and incorporates current market assessments of the time value of money. The entity should not adjust the discount rate(s) for risks already reflected in the entity's cash flow estimates.

Future Events

28.39 An entity should incorporate a future event that may have an effect on an amount required to settle an obligation when there is objective evidence that the event will occur. In addition, the entity should take into account the effects of possible new legislation, when there is sufficient objective evidence that it is virtually certain the legislation will be enacted. For example, the cost of a future environmental cleanup may change due to changes in technology. If there is sufficient objective evidence these technology changes will happen, the entity should measure the provision taking the expected future cost reductions into account.

Expected Disposal of Assets

28.40 An entity recognizes gains on the expected disposal of assets in accordance with the guidance in the appropriate IFRS relating to the assets. An entity should not include these gains in measuring a related provision, even if the expected disposal is closely linked to the event giving rise to the provision. Refer to examples 5A and 5B in appendix A of IAS 37 for additional guidance on asset disposals.

Reimbursements

28.41 An entity may be reimbursed by another party for some or all of its expenditures to settle a provision. For example, reimbursement may occur for insurance contracts, product warranties, or indemnity clauses. An entity should only recognize a reimbursement when it is virtually certain that the entity will receive the reimbursement when it settles the obligation. The entity cannot recognize a reimbursement for an amount that exceeds the carrying value of the provision.

28.42 An entity can offset an expense relating to a provision against the amount recognized for reimbursement in the statement of profit or loss and other comprehensive income.

28.43 Usually, an entity remains liable for the entire amount of the provision and would have to settle if the other party defaulted on its reimbursement obligation. Under this circumstance, an entity should recognize a provision for the entire liability, and a separate asset for the reimbursement right, when the entity is virtually certain that it will receive reimbursement. When an entity is no longer required to settle the obligation, even if the other party fails to pay, no liability exists and the entity should not include those costs in the measurement of the provision.

28.44 When an entity is jointly and severally liable for an obligation, it considers the portion of the obligation that it expects the other party to settle a contingent liability.

Changes in Provisions

28.45 At the end of each reporting period, an entity reviews and adjusts its recognized provisions to reflect its best current estimate of the amount to be paid to settle the obligation. If the entity determined that a future outflow of reasons was no longer probable, it would reverse (derecognize) the provision.

28.46 When the entity measures the carrying value of the provision by determining the present value of future cash flows, the entity increases the carrying value of the provision in each period to reflect the passage of time and recognizes interest expense for the amount of the increase. Refer to chapter 24 of this book for additional information regarding borrowing costs.

Use of Provisions

28.47 An entity can only apply expenditures against the original provision to which they relate. IAS 37 prevents an entity from offsetting other expenditures against unrelated provisions. For example, an entity could only apply expenditures for product warranty repairs to the product warranty provision; it should not apply these expenditures to a provision for a legal dispute over an employee's wrongful termination.

Specific Application

Future Operating Losses

28.48 An entity should not recognize future operating losses as provisions because they do not meet the definition of a liability and or the other recognition criteria for provisions listed in paragraph 14 of IAS 37.

28.49 If an entity expects future operating losses, it should test assets for impairment in accordance with IAS 36, *Impairment of Assets*, because future losses may indicate that such impairments exist.

Onerous Contracts

28.50 An entity enters into many contracts. Some contracts can be cancelled without giving rise to an obligation whereas cancelling others may establish new rights and obligations of parties involved. An *onerous contract* occurs when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits the entity expects to receive from fulfilling the contract terms.

28.51 An entity measures a provision for a present obligation under an onerous contract, as long as the onerous contract is not an executory contract that is outside the scope of IAS 37.

28.52 The measurement of these unavoidable costs under an onerous contract should reflect the least net cost of exiting the contract. The least net cost is the lower of the following costs:

- Cost to fulfill the existing contract
- Any penalties or compensation that may arise from the entity's failure to do so

28.53 Prior to establishing a separate provision for the onerous contract, an entity should recognize any impairment losses on assets dedicated to fulfilling the contract in accordance with IAS 36.

28.54 Refer to example 8 in appendix A of IAS 37 for additional guidance on recognizing a provision on an onerous contract.

Restructuring

28.55 IAS 37 defines a *restructuring* as a program that is planned and controlled by management and materially changes either the scope of the business or the manner in which that business is conducted. An entity recognizes a provision for restructuring costs only when the general recognition criteria in paragraph 14 of IAS 37 are met. The following are examples of events that may fall under the definition of a restructuring:

- Termination or sale of a line of business
- Changes in the entity's management structure or reorganizations that have a material effect on the nature and focus of the entity's operations
- Closing or relocation of a business location or business activities
- Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations

28.56 Paragraph 72 of IAS 37 explains that a constructive obligation to restructure arises only when

- The entity has a detailed formal plan for the restructuring, identifying at least
  - the business or part of a business concerned.
  - the principal locations affected.
  - the location, function, and approximate number of employees who will be compensated for terminating their services.
  - the expenditures that will be undertaken.
  - when the plan will be implemented.
- The entity has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

28.57 Types of evidence that would indicate the implementation of a restructuring plan might include the following:

- The entity makes a public announcement describing the main features of its plan that would constitute a constructive obligation by creating valid expectations to other parties.
- The entity sells assets.
- The entity dismantles a plant.

28.58 When management or the board makes a public announcement describing the main features of the restructuring plan to those affected and creates valid expectations that the entity will carry out the plan before the end of the reporting period, a constructive obligation is created.

28.59 When an entity announces or starts the implementation of their restructuring plan after the reporting period, the entity should disclose information about the plan in accordance with the guidance in IAS 10, *Events After the Reporting Period*, if the restructuring is considered material and nondisclosure could influence the decisions of financial statement users.

28.60 Although a constructive obligation is not created solely by a management decision, a constructive obligation for restructuring may occur when board or management approval has been communicated to other parties, or it may require the approval of others, depending upon the ultimate authority vested in the board, the country of domicile, and the regulatory nature of the restructuring.

28.61 Until an entity commits to the sale of an operation, such as in a binding agreement to sell, no obligation exists, because an entity would be able to change its mind or take another course of action if it cannot find a buyer. If a restructuring is only part of a sale, constructive obligations may arise for the other parts of the restructuring before a binding sale agreement exists. In this case, the entity should apply the requirements of IAS 36 to review the assets of the operation for impairment.

28.62 An entity can only include direct expenditures that arise from the restructuring that are necessarily entailed by the restructuring and not part of an entity's ongoing activities in measurement of the restructuring provision. The entity does not include such costs as the costs of relocating and retaining staff, marketing, or its investment in distribution networks and systems because these costs relate to the future conduct of the entity's business.

28.63 Unless identifiable future operating losses relate to an onerous contract, an entity does not include these amounts in the measurement of the restructuring provision.

28.64 Gains on the expected disposal of assets are also not included in the measurement of the restructuring provision.

Disclosures

28.65 For each class of provision, an entity is required to disclose a description of the nature of the provision and the expected timing of settlements. An entity should also discuss any uncertainties in these estimates, including major assumptions about future events. An entity should disclose the amount of expected reimbursements, including any amount recognized as an asset.

28.66 The following information should be disclosed for each class of provision:

- A reconciliation of the beginning and end of period carrying amounts
- Additional provisions, including increases to existing as well as new provisions, made during the period
- Amounts used, such as those charged against the provision when they were incurred, and the reversal of unused amounts, during the period
- The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate

28.67 IAS 37 does not require an entity to provide comparative information.

28.68 Unless the possibility of any outflow in settlement is remote, an entity should disclose a brief description of each class of contingent liability at the end of the reporting period. When practicable, this disclosure should include an estimate of financial effect, discussion of uncertainties relating to possible outflows, and the possibility of reimbursement. Only when an inflow of benefits is probable should an entity disclose information about contingent assets and, when practicable, an estimate of the expected financial effect. When the impracticability exception is used, an entity should disclose that fact.

28.69 IAS 37 recognizes that disclosure of some of the required information on contingent liabilities can have a prejudicial effect on litigation or other disputes. In those cases, the entity need not disclose all of the required information. However, the general nature of the dispute should be disclosed and described, together with the reason why the entity has not provided all of the required information.

28.70 An entity should consider which provisions or contingent liabilities form a class, including whether the nature of the items are sufficiently similar for a single statement about them to fulfill the requirements for disclosures by class. In addition, when a provision and a contingency arise from the same set of circumstances, the entity should provide the disclosure in a way that shows the linkage between the provision and the contingency.

28.71 Refer to appendix D in IAS 37 for disclosure examples related to warranties, and decommissioning costs, as well as a disclosure exemption.

Chapter 29

Consolidated and Separate Financial Statements

Overview

29.01 This chapter describes the principles that an entity should apply in the presentation of consolidated financial statements when it controls one or more other entities (subsidiaries).

29.02 In addition to its consolidated financial statements, an entity may present separate, unconsolidated financial statements, whether required by local law or regulations, or voluntarily. This chapter also describes the accounting and disclosure requirements for the entity's investments in subsidiaries, joint ventures, and associates when it prepares separate financial statements, also referred to as company-only or parent-only financial statements.

Summary of Selective Accounting Guidance

29.03 International Financial Reporting Standard (IFRS) 10, *Consolidated Financial Statements*, was issued in May 2011 and establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

29.04 Concurrently, International Accounting Statement (IAS) 27, *Separate Financial Statements*, was revised in May 2011 to exclude guidance on presentation and preparation of consolidated financial statements and was given a new title. The current guidance in IAS 27 establishes the requirements that an entity should apply in preparing and presenting separate financial statements for investments in subsidiaries, joint ventures, and associates.

29.05 IFRS 12*, Disclosure of Interests in Other Entities*, issued in May 2011, and later revised in June 2012, replaced the disclosure requirements previously contained in IAS 27 for interests in other entities. IAS 27, IFRS 10, and IFRS 12 are all effective for annual periods beginning on or after January 1, 2013.

Scope

29.06 IFRS 10 applies to all entities, unless the entity is exempt by meeting all of the following conditions:

- The entity is a wholly-owned subsidiary or a partially-owned subsidiary of another entity and all its other owners, including those that are not entitled to vote.
  - The entity informed these owners that it does not intend to present consolidated financial statements.
  - All of these owners do not object.
- The entity's debit or equity instruments are not traded in a public market. A public market includes domestic or foreign stock exchanges and over-the-counter markets, including local or regional markets.
- The entity did not file and is not in the process of filing its financial statements with a securities or other regulatory organization for the purpose of issuing any class of financial instruments in a public market.
- The entity's ultimate parent or any intermediate parent prepares and presents consolidated financial statements that comply with IFRSs and are available for public use.

29.07 When an entity meets these conditions and elects not to present consolidated financial statements under this exemption, it should prepare separate financial statements in accordance with IAS 27.

29.08 An entity does not exclude investees from consolidation based on organizational structure. Therefore, IFRS 10 requires venture capital organizations, mutual funds, unit trusts, or similar entities to consolidate investments that they control. An entity also does not exclude investees from consolidation because the investee's business activities are dissimilar from the parent's or other group entity's activities.

29.09 IAS 27 does not mandate which entities provide separate financial statements. However, an entity applies the requirements of IAS 27 in accounting for investments in subsidiaries, joint ventures and associates, when local regulations require or it elects presentation of separate financial statements. An entity provides separate financial statements in addition to its consolidated financial statements.

29.10 IFRS 12 applies to all entities that have interests in any of the following:

- Subsidiaries
- Joint arrangements, including joint operations and joint ventures
- Associates
- Unconsolidated structured entities

29.11 However, the requirements of IFRS 12 do not apply to the following:

- Postemployment or other long term employee benefit plans within the scope of IAS 19, *Employee Benefits*
- Separate financial statements to which IAS 27 applies, unless the entity has interests in unconsolidated structured entities and its separate financial statements are its only financial statements
- An interest in a joint arrangement over which the entity does not have joint control, unless
  - the entity has significant influence over the joint arrangement, or
  - the interest is a structured entity
- An interest in another entity that is accounted for in accordance with IFRS 9, *Financial Instruments*, unless the interest is
  - an associate or joint venture measured at fair value through profit or loss in accordance with IAS 28, *Investments in Associates and Joint Ventures*; or
  - an unconsolidated structured entity

Consolidated Financial Statements

Determining Whether an Entity Is a Parent

29.12 IFRS 10 considers an entity to be a parent if it controls an investee. Therefore, to determine whether it is a parent, the entity assesses whether it has control; that is, whether its interest in the investee exposes or gives it rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Paragraph 7 of IFRS 10 provides the following necessary and sufficient conditions for the entity to control an investee:

- *Power.* The entity has power over the investee.
- *Variable returns.* The entity is exposed or has rights to variable returns from its involvement with the investee.
- *Linkage between power and returns.* The entity has the ability to use its power over the investee to affect the amount of its returns.

29.13 When assessing whether it controls an investee, the entity should consider all the facts and circumstances. For example, when two or more entities collectively control an investee and must act in concert to direct the investee's activities, no one entity has control over the investee.

Control: Assessing Power Over the Investee

29.14 An entity has power over an investee when it has existing rights that give it the current ability to direct the activities that significantly affect its returns from the investee. IFRS 10 refers to these activities as relevant activities. The entity's rights give it this power.

29.15 The entity may control an investee directly and solely through its voting rights granted by equity instruments, such as ordinary capital shares. Normally, an entity that holds a majority of voting rights controls the investee. Other cases may be more complex. For example, power may result from one or more contractual arrangements that the entity has with others who have the requisite voting rights. It is also not necessary for power to be absolute or exercised. For example, power may simply be the ability to prevent others from controlling the investee.

Control: Assessing Exposure to Return Variability

29.16 The entity is exposed or has rights to variable returns from its involvement in the investee when these returns vary as a result of the investee's performance. It is irrelevant whether these returns are only positive, only negative, or both.

Control: Link Between Power and Returns

29.17 An entity controls an investee not only when it meets the power and variable returns conditions described in the preceding paragraphs. The entity must also have the ability to use its power to affect the investee's performance and, hence, the returns it will receive as a consequence.

29.18 An entity with decision-making rights should determine whether it is a principal or an agent. Therefore, an entity that is an agent does not control the investee when it exercises the decision-making rights delegated to it.

Accounting Requirements

29.19 An entity is a parent and required to prepare and present consolidated financial statements when it determines that it controls one or more of its investees. A parent should prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances. A parent consolidates a controlled entity from the date it gains control, and stops on the date it loses control over the investee.

Consolidation Procedures

29.20 When preparing consolidated financial statements, the parent does the following:

- Combines the financial statements of the parent and its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses, and cash flows of the parent with those the subsidiaries.
- Eliminates the carrying value of its investment in each subsidiary and applies the guidance in IFRS 3, *Business Combinations,* to account for any related goodwill.
- Eliminates in full any intragroup assets and liabilities, equity, income, expenses, and cash flows relating to transactions between the parent and a subsidiary.
- Consider whether any intragroup losses indicate an impairment that it should recognize in the consolidated financial statements.
- Apply the requirements of IAS 12, *Income Taxes*, to temporary differences that may arise from elimination of profits and losses resulting from intragroup transactions.

29.21 When noncontrolling interests are in the net assets of the subsidiaries, the parent should

- present the noncontrolling interests within equity in the consolidated statement of financial position, separately from the equity of the owners of the parent, calculated as follows:
  - Determine the amount of the noncontrolling interests at the date of the original business combination calculated in accordance with IFRS 3; and
  - Recognize the noncontrolling interests' share of changes in equity since that date.
- allocate the profit or loss of the relevant subsidiaries and each component of other comprehensive income to the owners of the parent and the noncontrolling interests, based on present ownership interest without including the effect of existing potential voting rights, if any.

29.22 As described in the previous paragraph, an entity allocates other comprehensive income to the noncontrolling interests, even if the allocation results in a deficit balance.

29.23 IAS 27 does not address how an entity should account for business combinations and their effects on the consolidated financial statements, including the effect of any goodwill that arises as a result. Entities should apply the guidance in IFRS 3 to determine the accounting for business combinations and their effects on consolidation.

29.24 In addition, when preparing consolidated financial statements, an entity should do the following:

- Use uniform accounting policies (the parent's accounting policies) for like transactions and events in similar circumstances in the subsidiaries financial statements.
- Prepare all of the subsidiaries financial statements as of its reporting date.

29.25 When a subsidiary included in the financial statements uses a different policy than the one adopted by the parent, the parent makes appropriate adjustments to conform that subsidiary's financial statements before or as part of the consolidation procedures.

29.26 When a subsidiary prepares its financial statement as of a different date than the parent's statements, the subsidiary should prepare an additional set of financial statements as of the parent's reporting date, unless it is impracticable to do so. In the latter case, the parent should makes adjustments to the financial statements of the subsidiary for the effects of significant transactions that occurred between the date of the subsidiary's financial statements and its reporting date. In any event, IFRS 10 does not permit a difference in reporting dates for a parent and its subsidiaries of more than three months. When there is a difference, it should be the same difference from period to period.

Changes in Ownership and Loss of Control

29.27 A parent may lose control of a subsidiary for a variety of reasons. A parent also may lose control of a subsidiary without a change in ownership interest; for example, in a government or court-ordered takeover or through a contractual agreement with another entity.

29.28 When determining the proper accounting treatment for a change in ownership or loss of control, a parent should identify whether it lost control through one, or more than one, transaction or arrangement. It should consider the terms and conditions of these transactions and arrangements and their economic effects.

29.29 When a parent loses control of a subsidiary, it should account for this event as follows:

- Derecognize the carrying amounts of the following:
  - Subsidiary's assets, including goodwill, and liabilities as of the date the parent lost control
  - Noncontrolling interest, including any components of other comprehensive income
- Recognize the following:
  - Fair value of consideration received, if any
  - Distribution, if any, of the subsidiary's shares to owners, in their capacity as owners
  - Any retained investment in the former subsidiary at fair value as of the date it lost control
- Reclassify to profit or loss or transfer directly to retained earnings, if required by another IFRS, all amounts previously recognized in other comprehensive income
- Recognize in profit or loss any gain or loss for any difference resulting from derecognizing, recognizing, and reclassifying the items discussed previously

29.30 When an entity loses control of a subsidiary and remeasures any retained investment at fair value, it should account for that retained investment going forward in accordance with other applicable IFRSs. For example, if the entity retained significant influence, it should account for the investment using the equity method in accordance with IAS 28.

29.31 In contrast, when a change in ownership interests does not result in loss of control, the parent accounts for that change as an equity transaction. The entity adjusts its investment to reflect the changes in its relative interest in the subsidiary with any difference between the amount of the adjustment and the fair value of the consideration paid or received recognized directly in equity and attributed to the owners of the parent.

Separate Financial Statements

29.32 IAS 27 defines *separate financial statements* as those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which these interests or investments are accounted for at cost or in accordance with IFRS 9. An entity should not consider the following financial statements to be separate financial statements:

- Financial statements in which the entity accounts for investments in joint ventures or associates using the equity method
- Financial statements of entities that do not have subsidiaries, joint ventures, or associates

> ***Author's Note:*** If an entity has not yet applied IFRS 9, it should read any reference to IFRS 9 as a reference to IAS 39, *Financial Instruments: Recognition and Measurement*.

29.33 An entity that is exempt both from preparing consolidated financial statements in accordance with IFRS 10 and from applying the equity method to its investments in associates and joint ventures in accordance with IAS 28 may present separate financial statements as its only financial statements.

29.34 If an entity accounts for its investments in associates and joint ventures in its consolidated financial statements, in accordance with IFRS 9, it should account for these investments in the same way in its separate financial statements.

29.35 When an investment is classified as held for sale or discontinued operations, an entity should apply the requirements of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

29.36 An entity recognizes any dividends declared by these investees in profit and loss in its separate financial statements when its right to receive the dividend is established.

29.37 A parent may reorganize the group structure by creating a new entity to become the parent. When certain criteria are met, the new parent should account for this change as follows:

- Recognize and measure its investment in the original parent at cost in its separate financial statements
- Measure cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganization

29.38 An entity accounts for the change in group structure as described in the previous paragraph when all of the following criteria are met:

- The new parent issues equity instruments to the shareowners of the original parent in exchange for the all of the original parent's equity instruments.
- Immediately before and after this transaction, the assets and liabilities of both the new group and the original group are the same.
- The shareowners of the original parent have the same absolute and relative interests in the net assets of the new group that they had in the old group before the reorganizations.

Disclosure

Consolidated Financial Statements—IFRS 12

29.39 The objective of IFRS 12 is to require an entity to disclose information that enables users of the financial statements to evaluate the following:

- The nature of, and risks associated with, the entity's interests in other entities, which includes subsidiaries, associates, and joint ventures
- The effects of those interests on the entity's financial position, financial performance, and cash flows

29.40 To meet this objective, an entity should disclose the following:

- Significant judgments and assumptions it made in determining
  - the nature of its interest in another entity or arrangement (that is, control, joint control, or significant influence); and
  - the type of joint arrangement in which it has an interest (that is, a susbsidiary, associate, joint venture, or unconsolidated structured entity).
- Information about its interests in subsidiaries, associates, joint arrangements, and unconsolidated structured entities, so that users of the consolidated financial statements will
  - understand
    - composition of the group; and
    - interest that noncontrolling interests have in the group's activities and cash flows.
  - evaluate
    - nature and extent of significant restrictions on the ability to access or use assets and settle liabilities of the group;
    - nature of, and change in, risks associated with its interests in consolidated structured entities;
    - consequences of changes in its ownership interest in a subsidiary that do not result in loss of control; and
    - consequences of losing control of a subsidiary during the reporting period.

Refer to paragraphs 10–31 of IFRS 12 for additional guidance on the required disclosures.

Separate Financial Statements—IAS 27

29.41 An entity should apply all of the applicable IFRSs when providing disclosures in its separate financial statements, including the following disclosures specifically required by IAS 27:

- A statement to the effect that the financial statements are separate financial statements
- If applicable, that the entity used the exemption from consolidation in IFRS 10 and the following:
  - The name and principal place of business of the entity whose consolidated financial statements comply with IFRSs and have been produced for public use
  - The address where those consolidated financial statements are obtainable
- A list of significant investments in subsidiaries, joint ventures, and associates, including the following:
  - The name of the investees
  - The principal place of each investee's business
  - The entity's proportion of ownership interest and voting rights (if different)
- A description of the method used to account for the investments listed under the previous bullet item

Refer to paragraphs 15–17 of IAS 27 for additional guidance on the required disclosures.

Chapter 30

Accounting Policies, Changes in Accounting Estimates, and Errors

Overview

30.01 This chapter describes the criteria for selecting and changing accounting policies and the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and error correction.

Summary of Selective Accounting Guidance

30.02 International Accounting Standard (IAS) 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, is the primary accounting literature for selecting and changing accounting policies. This guidance also addresses the accounting and disclosure of changes in accounting estimates and error correction. IAS 1, *Presentation of Financial Statements*, provides guidance in regard to the disclosure requirements for accounting policies, except changes in those policies. For information on the guidance contained in IAS 1, refer to chapter 2, "The Conceptual Framework and Financial Statement Presentation," of this book.

Scope and Scope Exceptions

30.03 IAS 8 applies to all entities. The scope of IAS 8 and the discussion in this chapter includes the following:

- Selecting and applying accounting policies
- Accounting for changes in accounting policies
- Accounting for changes in accounting estimates
- Accounting for corrections of prior period errors

30.04 An entity accounts for the tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies in accordance with IAS 12, *Income Taxes*. Refer to IAS 12 and chapter 10, "Income Taxes," of this book for additional guidance on accounting for income taxes.

Accounting Policies

30.05 When preparing and presenting financial statements, an entity's selection of accounting policies indicate the specific principles, bases, conventions, rules, and practices that the entity will apply when preparing its financial statements. When an International Financial Reporting Standard (IFRS) specifically applies to a transaction, other event, or condition, an entity determines the accounting policy or policies it should apply by following the guidance in that IFRS. This chapter refers to the authoritative guidance applied in the selection and the application of accounting policies, collectively, as IFRSs.

30.06 Paragraph 5 of IAS 8 states that IFRSs are comprised of the following:

- IFRSs
- IASs
- Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC)

30.07 Guidance that is an integral part of IFRSs is mandatory. An entity should apply the accounting policies described in IFRSs to transactions, other events, and conditions in order to enhance the relevance and reliability of the financial statements and their comparability to other entities over time. An entity need not apply these policies if the entity deems their effect to be immaterial. However, it is not appropriate for an entity to make or not correct immaterial departures from IFRSs in an attempt to achieve a particular presentation of an entity's financial position, financial performance, or cash flows.

30.08 In the absence of an IFRS that specifically applies to a transaction, other event, or condition, an entity's management should use its judgment when developing and applying accounting policies. Paragraph 10 of IAS 8 states that the information that results from the entity's accounting policies should be

- relevant to the economic decision-making needs of users.
- reliable, in that the financial statements
  - represent faithfully the financial position, financial performance, and cash flows of the entity;
  - reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  - are neutral (that is, free from bias);
  - are prudent; and
  - are complete in all material respects.

30.09 When applying the guidance in paragraph 30.08, paragraph 11 of IAS 8 requires management to consider the following sources in descending order:

- IFRSs requirements dealing with similar and related issues
- Definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*

30.10 Providing no conflict with or contradiction to IFRSs exist, management may also consider the following:

- The most recent pronouncements of other standard-setting bodies, provided they use a similar conceptual framework to develop guidance
- Other accounting literature
- Accepted industry practices

30.11 The preceding sources are often collectively referred to as the "IFRS Hierarchy."

Consistency

30.12 An entity should select and consistently apply an accounting policy for similar transactions, other events, and conditions, unless IFRSs specifically require or permit categorization of items for which different policies may be appropriate. If an IFRS requires or permits the application of different accounting policies by categories of items, an entity should select and consistently apply an appropriate accounting policy.

Changes in Accounting Policies

30.13 An entity should apply an accounting policy consistently within a period and from one period to the next. IAS 8 permits a change in accounting policy only if

a. the change is required by IFRSs; or

b. the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events, or conditions on the entity's financial position, financial performance, or cash flows.

30.14 The following accounting policy decisions are not considered changes in accounting policy, as described in paragraph 16 of IAS 8:

- Application of an accounting policy for transactions, other events, or conditions that differ in substance from those previously occurring
- Application of a new accounting policy for transactions, other events, or conditions that did not occur previously or were immaterial

30.15 An example of an acceptable change in accounting policy is when an entity changes its measurement model for investment property from the cost model to the fair value model because it believes that there are reliable fair value measurements for these properties and fair value measurement will provide more relevant and useful information to users of its financial statements.

Application

30.16 Unless an entity accounts for a change in accounting policy that results from the initial application of an IFRS with specific transition provisions, the entity should account for a change in an accounting policy retrospectively, except to the extent that it is impracticable to determine either the period-specific or cumulative effects of the change.

30.17 When applying an accounting policy retrospectively, an entity should adjust the following:

- The opening balances of each affected component of equity for the earliest prior period presented
- Other comparative amounts disclosed for each prior period presented

30.18 When a change in an accounting policy results from an initial adoption of an IFRS, the entity should follow any specific transitional provisions, if any, in that IFRS; otherwise, the entity accounts for the change retrospectively.

30.19 An entity accounts for a voluntary change in an accounting policy retrospectively; however, early adoption of an IFRS is not considered a voluntary change in accounting policy.

30.20 In the absence of an IFRS that specifically applies to a transaction, other event, or condition, management may use their judgment and apply an accounting policy based on the most recent pronouncements of other standard-setting bodies, subject to the constraints described in paragraph 12 of IAS 8. If an entity chooses to change its accounting policy following an amendment to such pronouncement, the change is considered voluntary and the entity accounts for that change retrospectively.

30.21 When it is impracticable to determine the period-specific effect of a change in accounting policy, an entity should take the following steps:

- Adjust the carrying amounts of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable, which may be the current period.
- Make an offsetting adjustment to the opening balance of each affected component of equity for that period. Generally, the entity makes this adjustment to retained earnings, but it may be made to other equity components.

30.22 When it is impracticable to determine the cumulative effect at the beginning of the current period of applying a new accounting policy to all prior periods, an entity should adjust the comparative information prospectively from the earliest date practicable. When making this prospective change, the entity disregards any cumulative adjustments to assets, liability, and equity applicable to periods before that date.

30.23 For example, if a manufacturing company decides to change its method of applying overhead to its inventories from using an allocation based on direct labor hours to a method using a new standard cost system in the current year, under such circumstances, data to restate prior inventories may not be available and deemed impracticable to determine the period-specific effect or cumulative effects of the change.

Disclosure

30.24 Paragraphs 28–29 of IAS 8 require several disclosures for the initial application of an IFRS or a voluntary change in accounting policies in each of the following circumstances:

- The changes have an effect on current or prior periods.
- The changes would have had an effect except that it is impracticable to determine the amount of the adjustment.
- The changes might have an effect on future periods.

30.25 The required disclosures are the following:

- The nature of the change in accounting policy
- For the current period and each prior period presented, to the extent practicable, the amount of the adjustment
  - for each financial statement line item affected
  - if IAS 33, *Earnings Per Share*, applies to the entity, for basic and diluted earnings per share
- The amount of the adjustment relating to periods before those presented, to the extent practicable

30.26 For the initial application of an IFRS, the following additional disclosures are required in addition to the disclosures listed in paragraph 30.25:

- The title of the IFRS
- When applicable, that the change in accounting policy is made in accordance with its transitional provisions
- When applicable, a description of the transitional provisions
- When applicable, the transitional provisions that might have an effect on future periods

30.27 If retrospective application required by paragraph 19(a) or (b) of IAS 8 is impracticable for a particular prior period, or for periods before those presented in the financial statements, an entity should disclose the circumstances that led to the existence of that condition, and a description of how and from what date it applied the change in accounting policy. Refer to paragraphs 30.18–.19 for a listing of the requirements in paragraph 19(a) and (b) of IAS 8.

30.28 For a voluntary change in accounting policy, IAS 8 requires the entity to disclose the following information, in addition to the disclosures listed in paragraph 30.25:

- The reason why applying the new accounting policy provides reliable and more relevant information
- If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied

30.29 When the entity changes its accounting policy on the initial application of an IFRS or voluntarily, it need not repeat these disclosures in the financial statements of subsequent periods.

30.30 When an IFRS has been issued but is not yet effective or applied, paragraph 30 of IAS 8 requires the entity to disclose the following information:

- The fact that the IFRS has been issued, but is not yet effective, and has not been applied
- Known or reasonably estimable information relevant to assessing the possible affect that application of the new IFRS will have on the entity's financial statements in the period of initial application

30.31 In addition to the required disclosures in paragraph 30.25, an entity should consider disclosing the following information described in paragraph 31 of IAS 8:

- The title of the new IFRS.
- The nature of the impending change or changes in accounting policy.
- The date by which application of the IFRS is required.
- The date at which it plans to apply the IFRS initially, and either
  - a discussion of the effect that initial application of the IFRS is expected to have on the entity's financial statements, or
  - if that effect is not known or reasonably estimable, a statement to that effect.

Changes in Accounting Estimates

30.32 Because of the uncertainties inherent in business activities, an essential part of the preparation of an entity's financial statements is the use of reasonable estimates. These uncertainties cannot be measured with precision. However, when based on the most current available and reliable information and with the use of proper judgment, an entity can estimate measurements without undermining their reliability. Examples of accounting estimates include, but are not limited to, the following:

- Uncollectible accounts receivable
- Obsolete inventory
- Fair values of financial assets or financial liabilities
- Useful lives and residual value of property, plant, and equipment
- Warranty obligation provisions
- Fair value of identifiable intangible assets in a business combination

30.33 An entity may need to revise its estimates as circumstances change and more up-to-date information becomes available. Because revisions are based on new information, changes to an estimate are not considered an adjustment to a prior period or correction of an error.

30.34 Paragraph 35 in IAS 8 cautions that a change in the measurement basis applied is a change in an accounting policy; it is not a change in accounting estimate. It may be difficult for an entity to distinguish a change in an accounting policy from a change in accounting estimate. If so, the entity treats the change as a change in an accounting estimate.

30.35 When the effects of a change in an accounting estimate give rise to changes in assets and liabilities or relates to a component of equity, an entity adjusts the carrying amount of the related asset, liability, or component of equity in the period the change applies.

30.36 An entity should account for the effect of a change in an accounting estimate prospectively, by recognizing its effect in profit or loss in the period of change and in future periods if the change affects both. For example, consider the following changes in accounting estimates.

> Based upon current reliable information, a manufacturer determines that it should change its accounting estimate for bad debts due to recent economic circumstances. In addition, the useful life of a piece of factory equipment also has changed. The prospective application of each of these changes in estimates would yield different results.
>
> > *Change in the accounting estimate for bad debts.* The change in the estimated amount will only affect the current period expense, not the expense of future periods.
> >
> > *Change in the useful life of equipment*. The change in the estimated useful life will affect the amount of current and future depreciation expense over the remaining useful life of the equipment, thus affecting current and future profits or losses of the manufacturer.
>
> A manufacturer of high fashion clothing normally writes off its unsold inventory 12 months after the clothing is manufactured. Based upon current reliable information

regarding worsening economic conditions, the manufacturer has shortened the write-off period to 6 months after the clothing is manufactured.

Change in estimated obsolete inventory. The change in the estimated amount will only affect the current period expense, not the expense in future periods.

A manufacturer of home laundry and kitchen equipment has reduced its product warranty allowances in the current period after a comprehensive review of its warranty expenses over the past five years.

Change in the warranty obligation provisions. The change in estimated amount will affect current and future profits or losses of the manufacturer.

Disclosure

30.37 When there is a change in an accounting estimate, an entity should disclose the nature and amount of the change in accounting estimate that has an effect in the current period, or is expected to have an effect in future periods, unless it is impracticable to estimate that effect on future periods. When an entity does not disclose the effect on future periods because it is impracticable to estimate, it should disclose that fact.

Errors

30.38 Errors may arise in the recognition, measurement, presentation, or disclosure of elements in the financial statements. If the financial statements contain errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance, or cash flows, the financial statements do not comply with IFRSs.

30.39 Unless it is impracticable to determine either the period-specific or cumulative effect of the error, an entity should correct a material prior period error retrospectively in the first set of financial statements authorized for issue after their discovery by restating

a. the comparative amounts for the prior periods(s) presented in which the error occurred; or

b. the opening balances of assets, liabilities, and equity for the earliest prior period presented, if the error occurred before the earliest prior period presented.

30.40 If errors are discovered in the current period, before the financial statements are authorized for issue, an entity corrects these errors in that period.

30.41 When it may be impracticable to determine either the period-specific or the cumulative effect of an error, there is a limitation on retrospective restatement of the error. When it is impracticable to determine the period-specific effects of an error on comparative information for one or more of the prior periods presented, the entity restates the opening balances of assets, liabilities, and equity for the earliest period for which retrospective restatement is practicable.

30.42 When it is impracticable to determine the cumulative effect at the beginning of the current period of an error on all prior periods, an entity should prospectively restate the comparative information to correct the error from the earliest date practicable, and disregard the portion of the cumulative restatement of assets, liabilities, and equity that arises before that date.

Disclosure

30.43 IAS 8 requires the following disclosures for prior period errors; however, the entity is not required to repeat these disclosures in the financial statements of subsequent periods:

- The nature of the prior period error
- For each prior period presented, to the extent practicable, the amount of the correction
  - for each financial statement line item affected, and
  - if IAS 33 applies to the entity, for basic and diluted earnings per share
- The amount of the correction at the beginning of the earliest prior period presented

- If retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and when the error has been corrected

Retrospective Application and Retrospective Restatement

30.44 Difficulties arise that make it impracticable for the entity to

a. adjust comparative information for one or more prior periods to allow retrospective application, or

b. apply the retrospective restatement of a prior period error due to the inability to recreate information.

30.45 The development of estimates is potentially challenging when retrospectively applying an accounting policy, or making a retrospective restatement to correct a prior period error. Nonetheless, the objective of an estimate remains the same, and that is to reflect the current circumstances that existed when the transaction, other event, or condition occurred, and the entity should not use hindsight to adjust prior estimates. Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that

- provides evidence of circumstances that existed on the date(s) that the transaction, other event, or condition occurred.
- would have been available when the financial statements for that prior period were authorized for issue.

Chapter 31

Interim Financial Reporting

Overview

31.01 Entities may elect, and others are required, to publish an interim financial report in accordance with International Financial Reporting Standards (IFRSs). *Interim financial reports* provide updates on an entity's most recent complete set of annual financial statements and focus on new events and activities. This chapter describes the minimum content an entity should include in an interim financial report and the principles for recognition and measurement it should apply in either a set of complete or condensed financial statements for an interim period. The objective of the interim financial report is to provide timely and reliable information about an entity's financial condition, liquidity, and its ability to generate earnings and cash flows to the users of these statements.

31.02 An internal financial report provides information about an *interim period,* a period that is shorter an entity's full financial year. IFRSs do not mandate the frequency that an entity issues interim financial reports. Other parties, such as regulatory authorities, require entities within their jurisdiction to provide interim financial reports to shareholders and others interested parties. When issuing an interim financial report, the entity should presume that readers have access to the most recent set of annual financial statements and disclosures. An entity may include in the interim financial report either a set of complete financial statements or the minimum required condensed financial information, including interim notes that explain significant events and changes in financial position and performance since the end of the entity's most recent annual reporting period.

Summary of Selected Accounting Guidance

31.03 International Accounting Standard (IAS) 34, *Interim Financial Reporting*, is the primary accounting literature that establishes the requirements for entities that elect or are required to publish an interim financial report in accordance with IFRSs. IAS 34 provides guidance regarding the minimum content and the recognition and measurement principles the entity should apply in the financial statements that it includes in an interim financial report. International Financial Reporting Interpretations Committee (IFRIC) 10, *Interim Financial Reporting and Impairment*, provides guidance about whether an entity can recognize a reversal of goodwill impairment losses recorded in a previous interim period.

31.04 The guidance in IAS 1, *Presentation of Financial Statements*, describes the structure of a complete set of financial statements and IAS 33, *Earnings Per Share*, establishes the requirements for calculating and presenting earnings per share (EPS) in an interim financial report. Refer to chapters 2, "The Conceptual Framework and Financial Statement Presentation," and 14, "Earnings Per Share," of this book for a detailed discussion of these topics, respectively.

Scope

31.05 The scope of IAS 34 and this chapter applies to entities that elect or are required to publish an interim financial report in accordance with IFRSs.

31.06 An entity should evaluate each financial report, annual or interim, separately for compliance with IFRSs. Lack of compliance with IFRSs in an interim period does not prevent the annual financial statements from conforming to IFRSs, if they otherwise do. However, when an entity claims compliance with IFRSs in an interim financial report, that report must be in compliance with the requirements of IFRSs, including the required disclosures described in this chapter and IAS 34.

31.07 IAS 34 does not prescribe the length of an interim period other than to state that it should be shorter than an entity's full financial year. IAS 34 also does not mandate the frequency that an entity should issue interim financial reports. However, accounting bodies, governments, regulatory authorities, or others may require publicly traded entities to publish interim financial reports on a regular basis. Many publicly traded entities issue interim financial reports quarterly or semi-annually. Paragraph 1 of IAS 34 encourages publicly traded entities to

a. provide interim financial reports at least as of the end of the first half of their financial year, and

b. make their interim financial reports available no later than 60 days after the end of the interim period.

Presentation

31.08 IAS 34 permits the interim financial report to include either a set of complete financial statements as defined in IAS 1, or a set of condensed financial statements for the interim period. IAS 34 does not express a preference for either of these formats. However, IAS 34 requires the interim financial report to include, at a minimum, a set of condensed financial statements and specific explanatory disclosures. IAS 34 does not prohibit an entity's interim financial report from providing more than the minimum line items or explanatory disclosures.

31.09 If an entity prepared its most recent set of annual financial statements on a consolidated basis, then it should also prepare the interim financial report on a consolidated basis. However, if the annual consolidated financial statements included the separate annual financial statements of the parent company, IAS 34 neither requires nor prohibits the entity from including the parent company's separate statements in the interim financial report.

Minimum Components of an Interim Financial Report

31.10 IAS 34 requires an entity to include the following minimum components in the interim financial report:

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income, presented as either of the following:
  - Condensed separate income statement and condensed statement of profit or loss and other comprehensive income
  - Condensed single statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected explanatory notes (described in paragraph 31.33)

31.11 At a minimum, the format and content of the condensed interim financial statements should include the same headings and subtotals that were included in an entity's most recent annual financial statements, including additional line items or notes if their omission would mislead users of the financial statements. Refer to IAS 1 and chapter 2 of this book for guidance on the structure of financial statements.

31.12 In accordance with IAS 33, if applicable, the entity should present basic and diluted EPS for the interim period in the same statement that presents the components of profit and loss for the interim period. If the components of profit or loss are presented in a separate income statement, the entity presents basic and diluted EPS in that separate statement in accordance with paragraph 10A of IAS 24. Refer to chapter 14 of this book for a detailed discussion of basic and diluted EPS.

Complete Set of Interim Financial Statements

31.13 When an entity chooses to include a complete set of financial statements and note disclosures in an interim financial report, it should follow the guidance in IAS 1 regarding the form, content, and structure of those statements. Refer to IAS 1 and chapter 2 of this book for additional information about the components of a complete set of financial statements.

Comparative Periods

31.14 Paragraph 20 of IAS 34 requires interim reports to include the condensed or complete set of interim financial statements for the following periods:

- Statements of financial position
  - As of the end of the current interim period
  - As of the end of the comparable interim period of the immediately preceding financial year
- Statements of profit or loss and other comprehensive income (whether the entity chooses the one or two statement format for this statement)
  - For the current interim period
  - For the comparable interim period of the immediately preceding financial year
  - For the cumulative year-to-date period of the current financial year
  - For the comparable cumulative year-to-date period for the immediately preceding financial year
- Statements of changes in equity and statements of cash flows
  - For the cumulative year-to-date period of the current financial year
  - For the cumulative year-to-date period for the immediately preceding financial year

31.15 Some entities have highly seasonal operations that fluctuate from interim period to interim period. IAS 34 states that users would appreciate additional disclosure of information that describes the type and effects of seasonality on the entity's operations. IAS 34 encourages entities to provide disclosures that go beyond its requirements, including financial information for the 12 months up to the end of the interim period and comparative information for the prior 12 month's comparative information.

Materiality

31.16 Recognizing that interim period financial data may rely more heavily on estimations, an entity should apply the concept of materiality, as defined in the International Accounting Standards Board's *Conceptual Framework for Financial Reporting* (conceptual framework), when deciding how to measure, recognize, classify, or disclose information in the interim financial report. When making materiality assessments, an entity should determine what effect that omission or misstatement of information could have on the decisions of users of the interim financial statements. Other standards, such as IAS 1 or IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, contain specific disclosure and presentation requirements that may be applicable to the interim financial statements depending upon the entity's materiality assessments.

Measurement and Recognition

Accounting Policies

31.17 An entity's interim accounting policies should be the same as their annual accounting policies, except for changes in accounting policy made after the date of the most recent annual financial statements. The entity reflects these changes in accounting policy in the next annual financial statements. Refer to IAS 8 and chapter 30, "Accounting Policies, Changes in Accounting Estimates, and Errors," of this book for additional guidance on changes in accounting policy.

31.18 Whether an entity issues financial statements quarterly, semiannually, or only annually, should not affect the measurement of an entity's annual results. The frequency of interim reporting does not affect the annual results because interim periods are part of the larger financial year and the principles that the entity applies when recognizing assets, liabilities, income, and expenses remain the same for the interim period and the financial year as a whole. The requirement for consistent application of these principles is found in the conceptual framework and described in chapter 2 of this book.

31.19 For example, the principles for recognizing and measuring losses incurred from inventory write-downs, restructurings, or impairments in an interim period are the same as those used in the annual financial statements. If there is a change in estimate in a subsequent interim period of that financial year, the entity adjusts the original estimate prospectively in the subsequent interim period either by an accrual or a reversal of a previously recognized amount. Refer to paragraph 31.23 for information on the treatment of goodwill impairments.

31.20 An entity should not defer costs that do not meet the definition of an asset and the asset recognition criteria at the end of the interim period for the same reason it would not defer such costs at the end of the financial year.

31.21 An entity recognizes income tax expense for each interim period using its best estimate of the weighted average annual income tax rate expected for the full financial year. It is not unusual for an entity to adjust amounts accrued in one interim period in subsequent periods if the estimate of the annual income tax rate changes.

31.22 When an entity publishes quarterly or semiannual interim financial reports, or both, it uses the measurement information available at the end of the interim period or shortly thereafter. The entity changes estimates prospectively in accordance with IAS 8. Refer to IAS 8 and chapter 30 of this book for guidance on application and disclosure of changes in accounting estimates.

31.23 IAS 36, *Impairment of Assets*, requires an entity to assess goodwill for impairment at the end of each reporting period, including interim periods. An entity cannot reverse goodwill impairment losses recognized in the annual financial statements. Similarly, if an entity recognizes a goodwill impairment loss in an interim period and conditions change in subsequent reporting periods, paragraphs 8 and 9 of IFRIC 10 state that an entity should also not reverse goodwill impairment losses or impairment losses in an investment in an equity instrument or financial asset carried at cost. However, IFRIC 10 explicitly prohibits an entity from using this guidance by analogy to other areas of potential conflict between IAS 34 and other IFRSs. Refer to IAS 36, IFRIC 10, and chapter 6, "Impairment of Assets," of this book for an additional discussion regarding impairment of assets.

Revenues

31.24 An entity should not anticipate or defer seasonal, cyclical, or occasional revenue in an interim financial statement unless IFRSs would permit or require the entity to anticipate or defer the revenue at the end of the financial year. Examples of such revenue include the following:

- Dividend income
- Royalty income
- Income from governmental grants

31.25 Seasonality, cyclicality, or occasional fluctuations in an entity's revenues does not affect the timing of revenue recognition. An entity recognizes revenue when it meets the recognition criteria in IAS 18, *Revenue*, and does not anticipate or defer revenue recognition based on other factors. Entities may also disclose additional information in their interim financial report to adequately describe the effects of normal or abnormal fluctuations in revenue recognized in interim periods so that users of these financial statements can better understand the information provided in the interim financial report.

Costs

31.26 In accordance with paragraph 39 of IAS 34, an entity anticipates or defers costs incurred unevenly during its financial year in its interim financial reports only if IFRSs would permit it to anticipate or defer that type of cost at the end of the financial year.

Use of Estimates

31.27 IAS 34 requires that the measurement procedures an entity applies for an interim financial report will ensure the information presented is both relevant and reliable. IAS 34 recognizes that financial statement measurements necessarily involve an entity to use reasonable estimates in arriving at the amounts recognized in the financial statements. However, although both interim and annual financial reports involve estimation, IAS 34 cautions that interim financial reports will often include and require a greater use of estimates.

Restatement

31.28 In accordance with IAS 8, an entity should apply its accounting policies consistently to a particular class of transactions throughout its financial year, within each interim period and from one period to the next, to prevent obscured operating results, interim allocation difficulties, and a lack of understandability of the interim financial report. IAS 8 permits an entity to change an accounting policy only if

a. IFRSs require the change; for example, when a newly issued IFRS requires a different policy, or

b. the change results in the entity providing more relevant and reliable information in its financial statements.

31.29 In accordance with IAS 8, when an entity has a change in accounting policy other than a change required by a new IFRS for which there is specific transition guidance, it will account for that change retrospectively by restating the following financial statements:

- Of the prior interim periods of the current financial year
- Of the comparable interim periods of any prior financial years that it will restate in the annual financial statements

31.30 At times, the entity may determine that it is impracticable for it to apply a change in accounting policy retrospectively. Under these circumstances, the entity should adjust comparative interim information prospectively from the earliest date practicable, but no later than the beginning of the current financial year.

31.31 Refer to IAS 8 and chapter 30 of this book for guidance regarding accounting policies, changes in accounting estimates, and errors. In addition, refer to the illustrative examples that accompany IAS 34 for examples of the application of recognition and measurement principles in interim financial reports.

Disclosure

31.32 IAS 34 presumes that users of the interim financial report will have access to the most recent annual financial statements. Therefore, it is unnecessary for the entity to duplicate information previously reported in the notes to those annual financial statements. Instead, IAS 34 requires the entity to provide an explanation of events and transactions that are significant and enhance a reader's understanding of changes in the entity's financial position and performance since the end of their last annual reporting period. IAS 34 provides a nonexhaustive list of events and transaction and would require disclosure if significant, including the following:

- Impairment losses on inventories, financial assets, property, plant, and equipment, intangible assets, or other assets, and reversals of such losses
- Reversals of restructuring provisions
- Acquisitions of, or commitments to, purchase property, plant, and equipment
- Litigation settlements

Refer to paragraphs 15 and 15A–C of IAS 34 for additional items on this list.

Selected Explanatory Notes

31.33 In addition to the required disclosures about significant transaction and events, the entity should provide, subject to normal materiality assessments, the following explanatory notes on a financial year to date basis:

- Statement that the accounting policies and computation methods used in the interim financial statements are the same as those used in the most recent annual financial statements or, if there has been a change to these policies or methods, a description of the nature and the effect of the change.
- Description of the cyclicality or seasonality of interim operations.

- Description of the nature and amounts of the following:
  - Items that are unusual due to their nature, size, or incidence that affected assets, liabilities, equity, net income, or cash flows; and
  - Changes in estimates of amounts reported in prior interim periods of the current or prior financial year, and the material effect, if any, in the current interim period.
- Description of issues or repurchases of equity securities or repayment of debt.
- Description of dividends paid either in the aggregate or per share separately for ordinary and other shares.
- Segment information, if applicable, in accordance with IFRS 8, *Operating Segments*, including the following:
  - Segment profit or loss.
  - If included in the measure of segment profit or loss regularly provided to and reviewed by the chief operating decision-maker,
    - revenues from external customers, and
    - intersegment revenue;
  - Total segment assets and liabilities if regularly provided to and reviewed by the chief operating decision-maker.
  - Differences from the last annual financial statements
    - in the basis of segmentation,
    - in the basis for measurement of segment profit or loss,
    - material change in the amount disclosed for segment assets and liabilities, and
    - changes in contingent assets and/or contingent liabilities.
  - Reconciliation of the total profit or loss of reportable segments to the entity's reported profit or loss before income tax expense (benefit) and discontinued operations. If the entity allocates income tax expense (benefit) or other items to reportable segment items, then the entity may reconcile total segment profit or loss to profit or loss after those items. An entity should separately identify and describe any material reconciling items.

    (Refer to IFRS 8 and chapter 32, "Operating Segments," of this book for additional guidance regarding reporting information about operating segments.)
- Material events not reflected in the interim financial statements that occurred after the end of that interim period.
- Changes in the interim period that affect the composition of an entity (for example, business combinations, loss or gain of subsidiary control, restructurings), including
  - changes in contingent assets or liabilities, or both, since the end of the last annual reporting period.

Compliance With IFRSs Disclosures

31.34 Compliance with IFRSs means complying with all IFRS requirements. IAS 34 requires the entity to make an explicit, unreserved statement that the interim financial statements are in compliance with IFRSs.

Annual Financial Statement Disclosures

31.35 If an entity does not publish a separate final interim financial report, but an estimate of an amount reported in a previous interim period changed significantly during the final interim period, the entity should disclose the nature and amount of the change in the notes to the annual financial statements for that fiscal year.

31.36 An entity should also disclose the nature and amount, if practicable, of changes in accounting estimates that have a material effect in the current period or an expected material effect in subsequent periods. These disclosures are narrow in scope and relate only to the change in estimate.

31.37 IAS 34 does not require entities to include any other interim period information in their annual financial statements. Refer to IFRIC 10 for additional guidance about this disclosure. Refer to chapter 30 of this book for a detailed discussion of changes in accounting estimates and the application of IAS 8.

Chapter 32

Operating Segments

Overview

32.01 This chapter describes the manner in which an entity reports information about its operating segments in the annual financial statements and the disclosures an entity should provide about products and services, geographic areas, and major customers.

Summary of Selected Accounting Guidance

32.02 International Financial Reporting Standard (IFRS) 8, *Operating Segments*, is the primary accounting literature for guidance on reporting operating segments in an entity's annual financial statements. The guidance in International Accounting Standard (IAS) 34, *Interim Financial Reporting*, addresses the reporting of selected information about an entity's operating segments when an entity issues interim financial statements. Refer to IAS 34 and chapter 31, "Interim Financial Reporting," of this book for additional guidance regarding interim reporting. These standards apply unless another IFRS requires or permits a different application.

Scope and Scope Exceptions

32.03 This chapter and IFRS 8 apply to the separate or individual financial statements of an entity or to the consolidated financial statements of a group with a parent, when one of the following criteria is met:

- The entity's debt or equity instruments are traded in a public market.
- The entity files, or is in the process of filing, its financial statements with a regulator or a securities commission for the purpose of issuing any class of instrument in a public market.

32.04 If an entity is within the scope of IFRS 8 and its financial report contains both consolidated and separate (parent-only) financial statements, it is only required to provide segment information in the consolidated financial statements.

32.05 When an entity that is not required to apply IFRS 8 chooses to voluntarily disclose information about segments that does not comply with IFRS 8, the entity should not describe that information as segment information. For example, an entity not required to comply with IFRS 8 may wish to voluntary disclose sales information by segment without also disclosing segment profit or loss, which is a requirement under IFRS 8. In this case, IFRS 8 prohibits the entity from using the label "segment information" for that sales data.

32.06 IFRS 8 does not consider an entity's postemployment benefit plan to be an operating segment.

Segments

Operating Segments

32.07 Paragraph 5 of IFRS 8 defines an *operating segment* as a component of an entity

- that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses relating to transactions with other components of the same entity,
- whose operating results are regularly reviewed by the entity's chief operating decision-maker (CODM) to make decisions about allocating resources to a segment and to assess a segment's performance, and
- for which discrete financial information is available.

32.08 Certain business activities, such as start-up operations, that have yet to earn revenues, may meet the definition of an operating segment in IFRS 8. A component of the entity that sells exclusively or primarily to other operating segments may also qualify as its own operating segment. However, not every part of an entity is necessarily an operating segment or part of an operating segment.

32.09 For example, it may be necessary for better overall management of an equipment manufacturer to maintain a location for its corporate headquarters. However, the existence of a corporate headquarters is incidental to the manufacturer's business activities. Regardless of whether the corporate headquarters has the ability to earn revenue incidental to the manufacturer's primary business activities, the entity should not consider the headquarters to be an operating segment.

32.10 The approach in IFRS 8 to determine an entity's operating segments is a *management approach*. This approach gives users of financial statements the opportunity to understand how the senior decision-maker controls the entity, allocates resources, and assesses the performance of the operating segments. Typically, the CODM makes this assessment. IFRS 8 considers the CODM to be a function within the entity, not necessarily a person with a specific title. Often, an entity's CODM is its CEO or COO, but the CODM can also be a group of executives or others.

32.11 An operating segment is often separately managed but it does not need to be. A manager of the operating segment or segments is held directly accountable to and maintains regular contact with the CODM to discuss the segment's operating activities, financial results, forecasts, and plans.

32.12 If more than one set of components of the entity have the characteristics described in paragraph 32.07 that would qualify them to be operating segments, but there is only one set for which segment managers are held responsible, then that set of components constitutes the operating segments.

32.13 The following example illustrates factors the entity should consider when determining operating segments.

Example 32-1

Facts

The management structure of an international plastics company holds some of their managers responsible and accountable for each plastic product line, whereas other managers are responsible and accountable for specific geographic regions worldwide.

In this type of management structure, some of the criteria used to assess whether a component of the entity is an operating segment overlap and apply to both product lines and geographic regions.

Analysis

Providing that the CODM regularly reviews the operating results of these overlapping components, the manufacturer should determine the best information to give users of the financial statements for evaluating the nature and financial effects of the entity's business activities and the economic in which it operates.

Reportable Segments

32.14 An entity should report separately financial and descriptive information about each operating segment or aggregations of operating segments, when specific qualitative thresholds are met. Operating segments or aggregations of operating segments that meet these thresholds are referred to as reportable segments.

32.15 Paragraph 12 of IFRS 8 states that operating segments usually exhibit similar long-term financial performance when they have similar economic characteristics. Therefore, an entity may aggregate operating segments if the segments have similar economic characteristics. Aggregating segments is consistent with the core principle of IFRS 8 to enable users of the financial statements to evaluate the nature and effects of the entity's business activities and economic environment when the segments are similar in each of the following respects:

- The nature of the production process
- The nature of the product and services

- The type or class of customer for products and services
- The method used to distribute products or provide services
- The nature of the regulatory environment, if applicable, such as insurance, banking regulations, or public utilities

Quantitative Thresholds

32.16 An entity should report aggregated or individual operating segment information when any of the following quantitative thresholds (10 percent tests) described in paragraph 13 of IFRS 8, are met:

- Reportable revenue, including both sales to external customers and intersegment sales and transfers, is 10 percent or more of the combined internal and external revenue of all operating segments.
- The absolute amount of reported profit or loss is at least 10 percent or more of the greater, in absolute amount, of the combined reported profits of all operating segments that did not report a loss, and the combined reported loss of all operating segments that reported a loss.
- Assets are equal or greater than 10 percent of the combined assets of all operating segments.

32.17 There are no precise limits to the number of reportable segments an entity may disclose, but an entity should consider whether a practical limit has been reached when the number of reportable segments exceeds 10.

32.18 If the quantitative thresholds are not met, the information about an operating segment may still be considered reportable and separately disclosed if management believes that segment information would be helpful to financial statement users. If the segments meet the majority of the aggregating criteria, an entity may combine operating segments that do not meet quantitative thresholds but have similar economic characteristics.

32.19 An entity is required to identify reportable segments such that these segments report a minimum of 75 percent of the entity's total externally reported revenue (75 percent test). An entity may need to include as reportable segments operating segments that do not otherwise meet the quantitative thresholds until the 75 percent threshold is met. The remaining business activities and operating segments that an entity does not report separately are then combined and disclosed in an "all other segments" (or "other") category. The entity presents the all other segment separately from other reconciling items. The entity should describe the sources of revenues included in the all other segments category.

32.20 Operating segments may meet the quantitative thresholds in one period, but not in the next. For example, a reportable segment may no longer meet a quantitative threshold as a result of a business acquisition or sale. When this occurs, and an entity presented a reportable operating segment in the immediately preceding period, it should continue to report that operating segment separately in the current period if there is continuing significance to users of the financial statements.

32.21 When an entity identifies a new reportable segment in the current period, in accordance with the quantitative thresholds, it should restate the information from the prior period for comparative purposes. An entity should report this information, even if that segment did not meet the reportable criteria in the prior period, unless the necessary information is not available and the cost to obtain it would be excessive.

The following provides an example of the calculations used to determine reportable segments on the basis of profit or loss:

Segment	*Revenue*	*Profit (Loss)*	*Total Profit*	*Total Loss*
1	Currency unit (CU) 100,000	CU 7,000	CU 7,000	
2	140,000	33,000	33,000	
3	65,000	(15,000)		(15,000)
4	100,000	35,000	35,000	
5	90,000	(20,000)		(20,000)
6	89,000	(7,500)		(7,500)
	CU 584,000	CU 32,500	CU 75,000	CU 42,500

The combined reported profit of all segments reporting a profit is CU 75,000 and the combine loss of all segments reporting a loss is CU 42,500. Therefore, 10 percent of the combined profits is CU 7,500, and 10 percent of the combined losses is CU 4,250.

With the exception of segment 1, the absolute amounts of profits or losses for each segments is greater than or equal to CU 7,500 and CU 4,250. Therefore, these segments would qualify as reportable segments.

Segment 1 has a profit of CU 7,000, which is less than the threshold of CU 7,500 for profit-making segments. Management would further assess whether this segment meets other segment reporting criteria. In this example, revenue from segment 1 is 17 percent of total revenue (CU 100,000 ÷ CU 584,000), which exceeds the 10 percent threshold. Therefore, segment 1 meets the revenue threshold and the entity should report it separately.

Disclosures

General Information

32.22 IFRS 8 requires that an entity disclose general segment information with additional disclosures and reconciliations for each period for which it presents a statement of profit or loss and other comprehensive income.

32.23 An entity should disclose the following general information:

- Factors used to identify reportable segments, including the basis of the organization
- Types of products and services from which each reportable segment derives revenue

Profit or Loss, Assets, and Liabilities Information

32.24 An entity should report for each reportable operating segment a measure of profit and loss, total assets, and liabilities, if such amounts are regularly reported to the CODM. The entity should also disclose the following information, when the specified amounts are regularly reviewed by the CODM, even if it is not included in the reportable segment's profit and loss:

- Revenue from external customers and transactions with the entity's other operating segments
- Interest revenue
- Interest expense
- Depreciation and amortization
- Material items of income and expense disclosed in accordance with paragraph 97 of IAS 1, *Presentation of Financial Statements*
- Income tax expense or income
- An entity's interest in the profit or loss of associates and joint ventures that are accounted for by the equity method
- Material noncash items other than depreciation and amortization

32.25 With respect to the disclosure of interest, the entity should report interest revenue and interest expense separately for each reportable segment, except under specific circumstance when net interest revenue is used to assess the performance of the segment. In the latter situation, an entity may report that segment's interest revenue, net of interest expense, and disclose that it has done so.

32.26 In addition, in accordance with paragraph 24 of IFRS 8, an entity should disclose specified amounts for each reportable segment, when these amounts are

a. included in the measure of segment assets reviewed by the CODM, or

b. regularly provided to the CODM, even if not included in the measure of segment assets.

32.27 These specified amounts are

- the amount of investments in associates and joint ventures accounted for by the equity method.
- additions to noncurrent assets, excluding additions to financial instruments, deferred taxes, net defined benefit assets, and rights that arise under insurance contracts.

Measurement Information

32.28 The amount of each segment item reported includes the same adjustments and eliminations used when preparing the entity's consolidated financial statements, provided that these adjustments and eliminations are used by the CODM to make decisions and performance assessments about the reportable segments. The entity should use a reasonable basis if it allocates amounts, such as profit and loss, among the reportable segments.

32.29 The CODM may use one or more measures when making decisions and assessing segment performance. These measurements should be consistent with the principles used in measuring corresponding amounts in the entity's financial statements.

32.30 An explanation of the measurements of each reportable segment's profit or loss, assets, and liabilities should include the basis of accounting for any transaction between reportable segments, along with disclosures regarding the nature of any differences between the following, if not apparent from the reconciliations required by paragraph 28 of IFRS 8:

- The reportable segments' profit or loss and the entity's profit or loss
- The reportable segments' assets and the entity's assets
- The reportable segments' liabilities and the entity's liabilities

32.31 The entity should also disclose the following:

- Any changes from prior periods in the measurement method used to determine reported segment profit or loss, and the effect, if any, of those changes on the measurement of segment profit or loss
- The effect of any asymmetrical allocation to reportable segments, such as the allocation of amortization expense to a segment without allocating the related intangible asset to that segment

Reconciliation Information

32.32 Paragraph 28 of IFRS 8 requires the entity to provide reconciliations of the following:

- Total of the reportable segments' revenues to the entity's revenues
- Total of the reportable segments' profit or loss before tax expense (tax benefit) and discontinued operations and the entity's profit or loss before tax expense (tax benefit) and discontinued operations
- Total of the reportable segments' assets and the entity's assets
- Total of the reportable segments' liabilities and the entity's liabilities
- Total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity

32.33 All reconciling items that are material should be separately identified and described, such as material adjustments that arise for different accounting policies.

32.34 For each date that the entity presents a statement of financial position, IFRS 8 requires a reconciliation of the amounts in the reportable segments' statements of financial position to the amounts in the entity's statement of financial position.

The following provides an example of the reconciliations for total losses and total assets.

Reconciliations of the total segment amounts to respective items included in financial statements are as follows:

	2012
(millions of CU)	
Total segments' loss	(1,350)
Share of profit from investments accounted for using the equity method	8
Other corporate items	(500)
Eliminations	185
Group loss	(1,580)
Interest expense, net	(800)
Loss before income taxes	(2,380)
Total segments' assets	53,000
Investments accounted for using the equity method	4,000
Income tax assets	3,000
Unallocated financial assets (including liquidity) and assets from defined benefit plans	13,000
Other corporate items and eliminations	(10,000)
Group assets	63,000

The reconciliation includes corporate items for which headquarters are responsible. Transactions between the segments are eliminated in the consolidation process and the eliminated amounts are included in the reconciliation.

Restatement of Reported Information

32.35 An entity may sometimes change its approach to determining resource allocation and performance assessment of reportable segments. When this change results in a change in the composition of reportable segments, the entity should restate the corresponding information for prior periods, including interim periods, unless the information is not available and the cost to obtain it would be excessive. An entity should disclose whether it has restated the earlier period information following a change in the composition of reportable segments.

32.36 If an entity does not restate the information from prior periods to reflect the change, then the entity should disclose, in the year the change occurs, reportable segment information for the current period on the old and new basis of segmentation, unless the necessary information is not available and the cost to obtain it would be excessive.

Entity-Wide Disclosure Information

32.37 An entity should disclose information about an entity's products and services, geographical areas, and major customers, if not already disclosed elsewhere as part of reportable segment information. IFRS 8 requires these disclosures for all entities within its scope even those that have a single reportable segment.

32.38 An entity should disclose the following amounts based on the financial information used to produce its overall financial statements, unless the necessary information is not available and the cost to obtain it is excessive:

- Revenue from external customers for each product and service, or group of similar products and services
- Geographical information

32.39 If the necessary information is not available and the cost to obtain it would be excessive, an entity should disclose that fact.

32.40 An entity should disclose the following geographical information:

- Revenue from external customers attributed to
  - an entity's country of domicile; and
  - all foreign countries in total from which the entity derives revenue, and if material, these revenues should be disclosed separately.
- The basis for attributing revenue from external customers to individual countries.
- Noncurrent assets, excluding financial instruments, deferred taxes, net defined benefit assets, and rights arising under insurance contracts located in
  - an entity's country of domicile; and
  - all foreign countries in total from in the entity hold assets, and if material, these assets should be disclosed separately.
- Additional information such as subtotals for groups of countries geographical information may also be provided.

32.41 An entity should disclose information about the extent of its reliance on major customers. If revenues from transactions with a single external customer are 10 percent or more of an entity's total revenue, the entity should disclose the following for each major customer meeting the 10 percent criteria:

- The total amount of revenue from each major customer
- The identity of the segment or segments reporting the revenue
- The identity of a customer or the specific amount of revenue each segment reports from each major customer need not be disclosed

32.42 When an entity is aware that a group of entities are under common control, including governmental customers, whether national, state, provincial, local, or foreign, the entity should consider these customers to be a single customer for reporting purposes.

Chapter 33

Agreements for the Construction of Real Estate

Overview

33.01 Some entities in the real estate industry construct real estate, either directly or through the use of subcontractors. These entities may enter into agreements with one or more buyers to sell the real estate under construction prior to its completion. Such agreements may be for residential, commercial, or industrial real estate. With respect to residential real estate, a buyer generally pays a deposit that is refundable only if the entity fails to deliver the completed real estate in accordance with the contract terms, with final payment due at delivery. With respect to commercial and industrial real estate, buyers typically make progress payments between the time they enter into the agreement and completion of the contract.

33.02 The discussion in this chapter describes how an entity determines whether it accounts for such an agreement for the construction of real estate in accordance with the International Financial Reporting Standards (IFRSs) relating to construction contracts or to revenue. This chapter also describes the disclosure requirements for entities in the real estate industry that enter into these contracts.

Summary of Selected Accounting Guidance

33.03 The primary accounting literature relating to the agreements for the construction of real estate are International Financial Reporting Interpretations Committee (IFRIC) 15, *Agreements for the Construction of Real Estate*, International Accounting Standard (IAS) 11, *Construction Contracts*,[1] and IAS 18, *Revenue*.

Scope and Scope Exceptions

33.04 This scope and the discussion of this chapter is limited only to providing guidance to determine whether an agreement for the construction of real estate is a construction contract within the scope of IAS 11 or a contract for the sale of goods within the scope of IAS 18.

33.05 IFRIC 15 applies to the accounting for revenue and associated expenses for the construction of real estate, directly or through the use of subcontractors, including the delivery of other goods and services when their delivery is part of this agreement.

33.06 This chapter and IFRIC 15 assume that the entity has previously done an analysis of the real estate agreement. The results of this analysis confirm that the entity

- will not retain continuing managerial involvement to the degree normally associated with ownership or effective control over the real estate asset.
- would not meet the criteria in IFRSs to recognize revenue for some or all of the consideration.

33.07 If the entity is precluded from recognizing revenue for some of the consideration, the guidance in IFRIC 15 only applies to the part of the agreement for which the entity will recognize revenue.

[1] Guidance regarding International Accounting Standard 11, *Construction Contracts*, has not been included in this discussion because it is beyond the scope of this book.

> ***Author's Note***: The International Accounting Standards Board and the Financial Accounting Standards Board issued an exposure draft, *Revenue from Contracts with Customers*, in November 2011. It has an expected completion date of June 30, 2013. When finalized, this standard will provide enhanced disclosures and clarify the accounting for contract costs associated with the agreements addressed in this chapter and IFRIC 15.

Recognition

Accounting for Revenue From Construction of Real Estate

33.08 An entity may enter into a single agreement to construct real estate that includes additional contractual obligations for the delivery of goods and services. In accordance with paragraph 13 of IAS 18, the entity may need to split the agreement into separately identifiable components for revenue recognition purposes. One of these components is construction of the real estate. An example of a single agreement with separately identifiable components includes an agreement for the sale of land, construction of an office building on that land, and an agreement to provide property management services for a period of time after delivery of the land and building to the buyer.

33.09 After identifying the components of the agreement, the entity allocates the fair value of the total consideration receivable to each component. If the entity identifies separate components, it applies the guidance in IFRIC 15 to the component for the real estate construction to determine whether that component is within the scope of IAS 11 or IAS 18. If the component for real estate construction is a construction contract within the scope of IAS 11, the entity also applies the segmenting criteria in IAS 11 to further determine the timing of revenue recognition on that contract.

Determining Whether the Agreement Is Within the Scope of IAS 11 or IAS 18

33.10 Determining whether an agreement to construct real estate is within the scope of IAS 11 or IAS 18 requires judgment and depends upon the following:

- Terms of the agreement
- All the surrounding facts and circumstances

33.11 The fundamental decision is whether the agreement is

- a *construction contract* as defined in IAS 11; that is, a contract specifically negotiated for the construction of an asset or combination of assets that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose; or
- a contract to purchase a good at some point in the future, similar to placing an order for a piece of furniture that is manufactured on demand.

33.12 A key difference in these two contracts is whether the buyer specifically negotiates the terms of the contract with the seller or whether the seller specifies the terms of the contract and the buyer has little or no discretion to modify these terms.

33.13 With respect to agreements to construct real estate, IFRIC 15 further explains that these agreements meet the definition of a construction contract when the buyer is able to specify major structural elements of the design of the real estate before construction begins or specify major structural changes once construction is in progress, or both. The buyer need not exercise this power for the agreement to be a construction contract.

33.14 IFRIC 15 also contrasts construction contracts with agreements in which buyers have limited ability to influence the design of the real estate. When the buyer has the ability to select only from a range of designs or can make minor changes to the basic design, the agreement is for the sale of goods and is not a construction contract.

33.15 For example, an agreement for the sale of goods (house) occurs when the real estate developer builds houses in a subdivision and buyers select the basic style of the house (ranch, split level, cape cod, and so on) to be built on their lot and also select appliances, cabinet finishes, and paint colors. This contrasts with a buyer who hires a developer to construct a house in concert with an architect who designs the house to the buyer's specifications, which may change as the house takes shape.

Construction Contracts

33.16 When an agreement to construct real estate meets the definition of a construction contract and the entity can reliably estimate its outcome, the entity recognizes revenue using the percentage of the completion method in accordance with IAS 11.

Contracts to Render of Services

33.17 If the entity is not required to acquire and supply construction materials, the entity accounts for agreements only to render services in accordance with IAS 18. IAS 18 also requires the entity to recognize revenue by reference to the stage of completion of the transaction using the percentage of completion method. Therefore, the entity generally applies the requirements of IAS 11 in recognizing both revenue and the associated expenses.

Agreements for the Sale of Goods

33.18 If the entity is required to provide construction materials together with services in order to meet its contractual obligation to deliver real estate to a buyer, the agreement is a sale of goods and the entity recognizes revenue in accordance with the following criteria in paragraph 14 of IAS 18:

- *Risk and rewards criteria*. The entity transferred the significant risks and rewards of ownership of the goods to the buyer.
- *Control criteria*. The entity retains neither continuing managerial involvement to the degree associated with ownership nor effective control over the goods sold.
- *Probability criteria*. It is probable that the economic benefits associated with the transaction will flow to the entity.
- *Measurement reliability criteria*. The entity can measure both of the following amounts reliably:
  - Revenue
  - Costs incurred or to be incurred in respect of the transaction

33.19 IFRIC 15 separately addresses the following alternatives for entities meeting the risk and rewards and control criteria in paragraph 14 of IAS 18:

- As work in progress in its current state as construction progresses
- In its entirety at a single time (for example, at completion, at or during delivery)

33.20 When the entity meets the control criteria and the risk and rewards criteria during construction, it should recognize revenue by reference to the stage of completion using the percentage of completion method providing the probability and measurement reliability criteria for the sale of goods in IAS 18 are also met. Therefore, the entity generally applies the requirements of IAS 11 for recognizing revenue and the associated expenses on these transactions.

33.21 When the entity meets the control criteria and the risk and rewards criteria at the same time, the entity recognizes revenue and the associated expenses when all of the recognition criteria in IAS 18 are met.

33.22 When the real estate has already been delivered to the buyer, but the agreement requires the entity to perform additional work, the entity recognizes a liability and expense in accordance with IAS 18. The entity measures the liability in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Disclosure

33.23 When an entity recognizes revenue on agreements within the scope of IFRIC 15 using the percentage of completion method, it should disclose the following:

- How it determines which agreements meet all of the criteria in paragraph 14 of IAS 18 continuously as construction progresses
- The amount of revenue arising from such agreements in the period
- The methods used to determine the stage of completion of agreements in progress

33.24 For agreements described in the previous paragraph that are in progress at the reporting date, the entity should also disclose the following:

- The aggregate amount of costs incurred and recognized profits (less recognized losses) to date
- The amount of advances received

Chapter 34

Employee Benefits

Overview

34.01 *Employee benefits*, as defined in International Accounting Standard (IAS) 19, are all forms of consideration given by an entity in exchange for service rendered by employees or termination of employment. This chapter describes the accounting and disclosures required by employers for these benefits.

34.02 IAS 19 recognizes that an entity can provide employee benefits under formal agreements with individual or groups of employees, legislative requirements, industry arrangements, or informal arrangements that create constructive obligations. A *constructive obligation* is an obligation that derives from an entity's actions; that is, an entity indicates to other parties by its past actions, published policy, or current statements that it will accept certain responsibilities and, as a result, create a valid expectation with the affected parties that it will discharge those responsibilities. For example, an entity can have a constructive obligation for an employee benefit when it always has given its employees a set amount of money as a holiday bonus, even though the entity has no legal or contractual obligation to do so.

34.03 IAS 19 establishes separate requirements for four types of employee benefits: short-term benefits, long-term benefits, postemployment benefits, and termination benefits. Employee benefits include those provided directly to employees, their spouses or dependents, and others (for example, insurance companies) on behalf of employees. Employees include personnel providing services to an entity on a full-time, part-time, permanent, casual, or temporary basis, and also include directors and other management personnel.

Summary of Selective Accounting Guidance

34.04 IAS 19 prescribes the accounting and disclosure requirements for employee benefits. International Financial Reporting Interpretations Committee (IFRIC) 14, *IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, addresses when an entity should regard refunds or reductions in future contributions as available under the guidance in IAS 19; how minimum funding requirements affect the availability of those reductions in future contributions; and when a minimum funding requirement might lead to a liability.

Scope

34.05 An entity should account for all employee benefits in accordance with IAS 19, except those to which International Financial Reporting Standard (IFRS) 2, *Share-based Payment*, applies. This chapter and IAS 19 do not address reporting by employee benefit plans, which is covered in IAS 26, *Accounting and Reporting by Retirement Benefit Plans*.

Recognition and Measurement

Short-Term Employee Benefits

34.06 *Short-term employee benefits* are employee benefits (other than termination benefits) that are expected to be settled wholly within 12 months after the end of the annual reporting period in which the employees render the related service. Short-term benefits include salaries, wages, and Social Security contributions; paid sick leave or annual leave; profit sharing and bonuses; and nonmonetary benefits, such as medical care, housing, cars, and free or subsidized goods and services for current employees.

34.07 IAS 19 requires that an entity recognize the following for short-term employee benefits:

- A liability for the undiscounted amount of short-term benefits that it expects to pay for employee services, after deducting amounts already paid
- A corresponding expense in profit or loss, unless another IFRS permits an amount to be included in the cost of an asset

34.08 When amounts already paid exceed the undiscounted amount of the benefits, the entity should recognize an asset (prepaid expense).

34.09 With respect to short-term paid absences, an entity should recognize a liability for the expected cost. When an employee can accumulate paid absences (that is, the employee can carry forward his entitlement to a paid absence to future periods), the entity recognizes that the expected cost, as the employee's service, increases his entitlement to the benefit. Otherwise, the entity recognizes the expected cost when the absence occurs. An entity should measure the expected cost of accumulating paid absences as the additional amount it expects to pay as a result of the entitlement, carried forward to the next period.

34.10 An entity should recognize the expected cost of profit sharing and bonus plans when it has a present legal or constructive obligation to make payments as a result of past events and it can make a reliable estimate of its liability. An entity has a present obligation when it has no realistic alternative but to make the payments. Estimates should take into account the fact that some employees may leave without receiving a bonus. An entity should include any payments due beyond 12 months in long-term employee benefits.

Postemployment Benefit Plans

34.11 Postemployment benefits include retirement benefits, such as pensions, and other postemployment benefits, such as life insurance and medical care. IAS 19 establishes the requirements for accounting for both defined contribution and defined benefit postemployment benefit plans. *Defined contribution plans* are those in which the entity's legal or constructive obligation is limited to the agreed contributions to the plan. Therefore, the employee bears both the actuarial risk that the benefits will be less than expected and the investment risk that the assets will be insufficient to meet the expected benefits. An entity considers all other plans to be defined benefit plans for the purposes of accounting, in accordance with IAS 19.

Defined Contribution Plans

34.12 For defined contribution plans, an entity should recognize liabilities for contributions payable in exchange for employee service and a corresponding expense in profit or loss, unless the payment is appropriately included in the cost of an asset. When payments exceed the liability, an entity should recognize an asset (prepaid expense) for the excess. An entity should discount contributions payable beyond 12 months and should, in most circumstances, use a discount rate determined by reference to market yields on high-quality corporate bonds, consistent with the currency and estimated maturity of the postemployment benefit plan.

Defined Benefit Plans

34.13 Accounting for defined benefit plans under IAS 19 is more complex than that for defined contribution plans because actuarial assumptions are required to measure the obligation and the associated expense, possibly resulting in actuarial gains and losses. To determine the amount of the obligation and the associated expense it should recognize in the current period, an entity should take the following steps, in accordance with paragraph 57 of IAS 19:

- Apply an actuarial technique known as the projected unit credit method to estimate the cost of the benefit that employees have earned in return for their service in the current and prior periods. This method requires the entity to make actuarial assumptions about employee turnover and mortality, as well as future salary increases and medical costs.
- Discount the estimated benefit to determine the present value of the defined benefit obligation and current service cost.
- Determine the fair value of any plan assets.

- Determine the plan deficit or surplus by subtracting the fair value of the plan assets from the present value of the defined benefit obligation.
- Determine amounts to be recognized in profit or loss. These amounts include
  - current service cost,
  - past service cost and gain or loss on settlement, and
  - net interest on the net defined benefit liability.
- Determine the total amount of actuarial gains and losses and the amount to be recognized in other comprehensive income in the current period.

34.14 An entity should apply the requirements of IAS 19 not only to its legal obligations, but also to its constructive obligations, with the understanding that a constructive obligation exists when failure to pay benefits would result in unacceptable damage to an entity's relationship with its employees.

34.15 An entity should not recognize a defined benefit asset at an amount more than the present value of economic benefits available in the form of refunds or reductions in future contributions (asset ceiling). IAS 19 includes specific requirements for recognition of any gains or losses that might result from application of this constraint. IFRIC 14 provides guidance on the recognition of an entity's right to a refund or contribution reduction, as well as how a minimum funding requirement affects the availability of reductions in future contributions and might give rise to a liability.

34.16 Except to the extent that a cost is included in the cost of an asset, an entity should recognize the net total of the following amounts as an expense in profit or loss:

- Current service cost
- Interest cost on the defined benefit obligation
- Expected return on defined benefit plan assets and any reimbursement rights
- Actuarial gains or losses, if any (explained later in this chapter)
- Past service cost from amendments to the defined benefit plan
- Effect of any curtailments or settlements of the defined benefit plan
- Effect of the asset ceiling

34.17 Actuarial gains and losses result from increases or decreases in the present value of the defined benefit obligation and are caused by the following:

- Unexpectedly high or low rates of employee turnover, early retirement or mortality, or increases in salaries, benefits, or medical costs
- The effect of changes to assumptions concerning benefit payment options
- The effect of changes in estimates of future employee turnover, early retirement or mortality, or increases in salaries, benefits, or medical costs
- The effect of changes in the discount rate

State and Multiemployer Plans

34.18 *Multiemployer plans* are plans that pool assets contributed by entities that are not under common control; use those assets to provide benefits to employees of more than one entity; and determine benefit levels without regard to the identity of the employee's employer. These plans are not state plans and can be either defined contribution or defined benefit plans. When these plans are defined benefit plans, an entity should apply defined benefit plan accounting in accordance with IAS 19 unless sufficient information is not available. In the latter case, the entity should apply defined contribution accounting but disclose the fact that the plan is a defined benefit plan and the reason(s) why sufficient information is not available to enable it to account for the plan as a defined benefit plan.

34.19 When the risks of a defined benefit plan are shared among entities under common control, the plan is not considered to be a multiemployer plan. An entity participating in such a plan should not claim it does not have sufficient information to apply defined benefit plan accounting. IAS 19 provides guidance about how an individual entity in this situation should account for its participation in these plans in its separate financial statements. In addition, the entity should consider its participation in these plans to be a related party transaction and provide additional disclosures in accordance with IAS 24, *Related Party Disclosures*.

34.20 An entity should account for state plans (established by legislation for all entities or all entities in a particular category) as if the plans were multiemployer plans.

Insured Benefits

34.21 An entity should treat insurance premiums paid to fund a postemployment benefit plan as a defined contribution plan unless it has a remaining legal or constructive obligation to pay benefits or additional amounts if the insurer does not pay. An entity should account for any remaining legal or constructive obligation as a defined benefit plan.

Other Long-Term Employee Benefits

34.22 An entity might offer other types of long-term employee benefits, such as sabbaticals, housing, disability benefits, or deferred compensation. An entity should recognize and measure a liability and related expense for these benefits in a manner similar to that for postemployment benefit obligations except that it recognizes any actuarial gains and losses and past service cost immediately in profit or loss.

Termination Benefits

34.23 Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either

a. an entity's decision to terminate an employee's employment before the normal retirement date; or

b. an employee's decision to accept an offer of benefits in exchange for the termination of employment.

34.24 An entity should recognize termination benefits as a liability and expense at the earlier of the following dates:

- When the entity can no longer withdraw the offer of those benefits
- When the entity recognizes costs for a restructuring that is within the scope of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and involves the payment of termination benefits

34.25 IAS 19 considers an entity no longer able to withdraw an offer of termination benefits when the employee accepts the offer or when a restriction on the entity's ability to withdraw the offer takes effect, whichever occurs earlier. In addition, an entity can no longer withdraw an offer when the entity has communicated to affected employees a plan of termination that meets the following criteria, described in paragraph 167 of IAS 19:

- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
- The plan identifies the number of employees who will be terminated, their job classifications or functions, locations, and the expected completion date.
- The plan establishes the termination benefits that employees will receive in sufficient detail so that employees can determine the type and amount of benefits they will receive when their employment is terminated.

34.26 If the termination benefits are an enhancement to postemployment benefits, the entity should apply the requirements for postemployment benefits. If the termination benefits are expected to be settled wholly before 12 months after the end of the reporting period in which the entity recognizes the termination benefit, the entity should apply the requirements for short-term employee benefits. Otherwise, the entity should apply the requirements for other long-term employee benefits.

Presentation and Disclosure

34.27 IAS 1, *Presentation of Financial Statements*, does not require an entity to show assets and liabilities associated with postemployment benefit plans as separate line items in a statement of financial position. However, IAS 19 prohibits an entity from offsetting assets and liabilities related to different plans in that statement, unless it has a legal right to use a surplus in one plan in order to settle a liability in another, and it intends to do so. IAS 19 does not provide guidance beyond that in IAS 1 on whether an entity should disaggregate these assets and liabilities into current and noncurrent portions.

Defined Contribution Plans

34.28 IAS 24 establishes the related party disclosures for key management personnel compensation and, together with the general guidance of IAS 1, specific disclosures about employee benefits. Although IAS 19 does not establish specific disclosures about short-term or long-term employee benefits, other than the subsequently discussed disclosures required for defined benefit and defined contribution plans, the requirements of IAS 1 and IAS 24 still apply.

34.29 With respect to defined contribution benefit plans, an entity should disclose the amount recognized as an expense during the period.

Defined Benefit Plans

34.30 With respect to defined benefit plans, an entity should disclose the nature of the benefits provided by the plan as well as a description of the regulatory framework in which the plan operates. In addition, the entity should describe the risks to which it is exposed, as well as any plan amendments, curtailments, and settlements.

34.31 An entity should disclose a reconciliation of the beginning and ending balances of the following, as stated in paragraph 140 of IAS 19:

- The net defined benefit liability (asset), showing separate reconciliations for the following:
  - The present value of the defined benefit obligation
  - Plan assets
  - The effect of any asset ceiling
- Reimbursement rights, if any

The entity should also describe the relationship between any reimbursement right and the related obligation.

34.32 In the reconciliation described previously, an entity should disclose, when applicable, the separate components of expense (current service cost, interest cost, and so on); contributions to the plan and payments to beneficiaries; effects of business combinations and disposals; and any foreign currency adjustments. An entity should also disclose the actuarial assumptions used to determine the present value of the defined benefit obligation, including a sensitivity analysis for each significant assumption as of the end of the reporting period to show the effect of possible changes to the assumptions.

Other Long-Term Employee Benefits

34.33 IAS 19 does not establish specific disclosures about other long-term employee benefits. However, the requirements of IAS 1 and IAS 24 apply for disclosures of total employee benefits expense and employee benefits for key management personnel, respectively.

Termination Benefits

34.34 IAS 19 does not establish specific disclosures about termination benefits. However, the requirements of IAS 1 and IAS 24 both apply. In addition, uncertainty about whether employees, or how many, will accept an offer of voluntary termination may give rise to a contingent liability. In this case and with respect to restructuring activities, an entity should recognize and disclose such a contingency, in accordance with IAS 37.

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