



MEMBERS' HANDBOOK

Update No. 219

(Issued 24 September 2018)

The following Standards, Interpretations and Amendments are effective for annual reporting periods beginning on or after 1 January 2018:

- HKFRS 9 (2014) *Financial Instruments*
- HKFRS 15 *Revenue from Contracts with Customers*
- HK(IFRIC) – Int 22 *Foreign Currency Transactions and Advance Consideration*
- *Annual Improvements to HKFRSs 2014-2016 Cycle*
- *Applying HKFRS 9 Financial Instruments with HKFRS 4 Insurance Contracts* (Amendments to HKFRS 4)
- *Clarifications to HKFRS 15 Revenue from Contracts with Customers*
- *Classification and Measurement of Share-based Payment Transactions* (Amendments to HKFRS 2)
- *Transfers of Investment Property* (Amendments to HKAS 40)

The consequential amendments arising from these Standards and Interpretations were previously set out in the Appendices to the respective Standards and Interpretations but are now incorporated into the text of the relevant Standards, Interpretations, Basis for Conclusions and Implementation Guidance.

<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>VOLUME II</u>		
<u>Contents of Volume II</u>	Discard existing pages i-iv & replace with revised pages i-iv.	Revised contents pages.
HONG KONG ACCOUNTING STANDARDS (HKAS)		
<u>HKAS 1 (Revised) Presentation of Financial Statements</u>	Replace the full set of HKAS 1 (revised August 2017) with HKAS 1 (revised September 2018).	Refer above.
<u>HKAS 2 Inventories</u>	Replace the cover page and pages 2, 8-9, 11-12, and 14-15 with revised cover page and pages 2, 8-9, 11-12 and 14-15.	
<u>HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors</u>	Replace the cover page and pages 2 and 19 with revised cover page and pages 2 and 19.	

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<u>HKAS 10 Events after the Reporting Period</u>	Replace the cover page and pages 2, 8 and 10-11 with revised cover page and pages 2, 8 and 10-11.	Refer page 1.
<u>HKAS 11 Construction Contracts</u>	Replace the cover page with revised cover page.	
<u>HKAS 12 Income Taxes</u>	Replace the cover page and pages 2, 16, 19A, 27 and 36 with revised cover page and pages 2, 16, 19A, 27 and 36.	
<u>HKAS 16 Property, Plant and Equipment</u>	Replace the cover page and pages 2, 6, 13, 16, 18A, 19-19A, 26 and 28 with revised cover page and pages 2, 6, 13, 16, 18A, 19-19A, 26 and 28.	
<u>HKAS 17 Leases</u>	Replace the cover page and pages 2 and 23 with revised cover page and pages 2 and 23.	
<u>HKAS 18 Revenue</u>	Replace the cover page with revised cover page.	
<u>HKAS 19 (2011) Employee Benefits</u>	Replace the cover page and pages 2, 98, 100-101 and 117-117A with revised cover page and pages 2, 98, 100-101 and 117-117A.	
<u>HKAS 20 Accounting for Government Grants and Disclosure of Government Assistance</u>	Replace the cover page and pages 2-3, 5, 9 and 11 with revised cover page and pages 2-3, 5, 9 and 11.	
<u>HKAS 21 The Effects of Changes in Foreign Exchange Rates</u>	Replace the cover page and pages 2, 4, 6, 10, 14 and 16 with revised cover page and pages 2, 4, 6, 10, 14 and 16.	
<u>HKAS 23 (Revised) Borrowing Costs</u>	Replace the cover page and pages 2, 5, 9, 14 and 16 with revised cover page and pages 2, 5, 9, 14 and 16.	
<u>HKAS 27 (2011) Separate Financial Statements</u>	Replace the cover page and pages 2, 13 and 19 with revised cover page and pages 2, 13 and 19.	

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<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>HKAS 28 (2011) Investments in Associates and Joint Ventures</u>	Replace the full set of HKAS 28 (revised January 2018) with HKAS 28 (revised September 2018).	Refer page 1.
<u>HKAS 32 Financial Instruments: Presentation</u>	Replace the cover page and pages 2, 5-6, 8-9, 11, 18-19, 21, 23-25, 27, 33 and 36 with revised cover page and pages 2, 5-6, 8-9, 11, 18-19, 21, 23-25, 27, 33 and 36.	
<u>HKAS 32 Financial Instruments: Presentation</u> <u>(Basis for Conclusions)</u>	Replace the cover page and pages 4, 11, 16, 19F and 20 with revised cover page and pages 4, 4A, 11, 16, 19F and 20.	
<u>HKAS 32 Financial Instruments: Presentation</u> <u>(Illustrative Examples)</u>	Replace the cover page and pages 3 and 5 with revised cover page and pages 3 and 5.	
<u>HKAS 33 Earnings per Share</u>	Replace the cover page and pages 2, 7, 12, 16 and 20 with revised cover page and pages 2, 7, 12, 16 and 20.	
<u>HKAS 34 Interim Financial Reporting</u>	Replace the cover page and pages 2, 6-9, 13, 13A and 14 with revised cover page and pages 2, 6-9, 13, 13A and 14.	
<u>HKAS 36 Impairment of Assets</u>	Replace the cover page and pages 2, 10-11, 41 and 47 with revised cover page and pages 2, 10-11, 41-41A and 47.	
<u>HKAS 36 Impairment of Assets</u> <u>(Basis for Conclusions)</u>	Replace the cover page and pages 2-4, 6, 8-9, 13, 42, 53 and 61 with revised cover page and pages 2-4, 6, 8-9, 13, 42, 53 and 61.	
<u>HKAS 36 Impairment of Assets</u> <u>(Illustrative Examples)</u>	Replace the cover page and pages 7 and 9 with revised cover page and pages 7 and 9.	
<u>HKAS 37 Provisions, Contingent Liabilities and Contingent Assets</u>	Replace the cover page and pages 2-4, 8, 13, 19A and 26 with revised cover page and pages 2-4, 8, 8A, 13, 19A and 26.	
<u>HKAS 38 Intangible Assets</u>	Replace the cover page and pages 2, 9-10, 30-31 and 35 with revised cover page and pages 2, 9-10, 30-31 and 35.	

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<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>HKAS 38 Intangible Assets (Basis for Conclusions)</u>	Replace the cover page with revised cover page. Insert page 36 after page 35.	Refer page 1.
<u>HKAS 39 Financial Instruments: Recognition and Measurement</u>	Replace the full set of HKAS 39 (revised November 2016) with HKAS 39 (revised September 2018).	
<u>HKAS 40 Investment Property</u>	Replace the cover page and pages 2-3, 6-7, 10, 14-15, 20, 23, 24, 24A, 24B, 26, 30-32 and 34-36 with revised cover page and pages 2-3, 6-7, 10, 14-15, 20-20A, 23, 24, 24A, 24B, 26, 30-32 and 34-36. Discard existing pages 21A-21B and 24C.	
<u>HKAS 41 Agriculture (Basis for Conclusions)</u>	Replace the cover page and pages 5, 13-14 and 16 with revised cover page and pages 5, 13-14 and 16.	

HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)

<u>HKFRS 1 (Revised) First-time Adoption of Hong Kong Financial Reporting Standards</u>	Replace the full set of HKFRS 1 (revised January 2017) with HKFRS 1 (revised September 2018).
<u>HKFRS 2 Share-based Payment</u>	Replace the cover page and pages 2, 4, 9, 11-12, 16, 21-23, 27 and 36 with revised cover page and pages 2, 4, 9, 11-12, 16, 16A, 16B, 21-23, 23A, 27 and 36-36A. Discard existing pages 42-46.
<u>HKFRS 2 Share-based Payment (Basis for Conclusions)</u>	Replace the cover page and pages 3-4A, 12, 14, 52, 55, 75-76 with revised cover page and pages 3-4A, 12, 14, 52, 52A, 52B, 55, 55A-55C and 75-76. Discard existing pages 77-81.
<u>HKFRS 2 Share-based Payment (Implementation Guidance)</u>	Replace the cover page and pages 2, 24 and 26 with revised cover page and pages 2, 24 and 26. Insert pages 26A-26F after page 26. Discard existing pages 33-38.

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<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>HKFRS 3 (Revised) <i>Business Combinations</i></u>	Replace the cover page and pages 1A, 10, 15, 17-19, 19A and 30-31 with revised cover page and pages 1A, 10, 15, 17-19, 19A and 30-31.	Refer page 1.
<u>HKFRS 3 (Revised) <i>Business Combinations</i> (Basis for Conclusions)</u>	Replace the cover page and pages 14, 41, 52, 55-56, 70, 74, 75A-75B, 82, 92-92A and 93 with revised cover page and pages 14, 41, 52, 55-56, 70, 74, 75A-75B, 82, 92-92A and 93.	
<u>HKFRS 3 (Revised) <i>Business Combinations</i> (Illustrative Examples)</u>	Replace the cover page and pages 3, 22, 24-26 and 28 with revised cover page and pages 3, 22, 24-26 and 28.	
<u>HKFRS 4 <i>Insurance Contracts</i></u>	Replace the full set of HKFRS 4 (revised January 2017) with HKFRS 4 (revised September 2018).	
<u>HKFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i></u>	Replace the cover page and pages 2, 8, 14 and 16 with revised cover page and pages 2, 8, 14 and 16.	
<u>HKFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> (Basis for Conclusions)</u>	Replace the cover page and pages 4-5, 14-17, 17A and 18 with revised cover page and pages 4-5, 14-17, 17A and 18.	
<u>HKFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> (Implementation Guidance)</u>	Replace the cover page and pages 6-7 and 9 with revised cover page and pages 6-7 and 9.	
<u>HKFRS 7 <i>Financial Instruments: Disclosures</i></u>	Replace the full set of HKFRS 7 (revised December 2016) with HKFRS 7 (revised September 2018).	
HKFRS 9 (2010) <i>Financial Instruments</i>	Discard the full set of HKFRS 9 (2010) (revised September 2014).	
HKFRS 9 <i>Financial Instruments (Hedge Accounting)</i>	Discard the full set of HKFRS 9 (issued December 2013).	
<u>HKFRS 9 (2014) <i>Financial Instruments</i></u>	Replace the cover page and pages 2-3 and 124-128 with revised cover page and pages 2-3 and 124-128. Discard existing pages 129-182.	

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<u>HKFRS 9 (2014) <i>Financial Instruments</i> (Basis for Conclusions)</u>	Replace the cover page and pages 2-3 and 280-287 with revised cover page and pages 2-3 and 280-287. Discard existing pages 288-315.	Refer page 1.
<u>HKFRS 9 (2014) <i>Financial Instruments</i> (Implementation Guidance)</u>	Replace the cover page and pages 2 and 71 with revised cover page and pages 2 and 71.	
<u>HKFRS 10 <i>Consolidated Financial Statements</i> (Basis for Conclusions)</u>	Replace the cover page and pages 2, 43-44, 48-49, 54-55 and 57 with revised cover page and pages 2, 43-44, 48-49, 54-55 and 57.	
<u>HKFRS 12 <i>Disclosure of Interests in Other Entities</i></u>	Replace the cover page and pages 2 and 9 with revised cover page and pages 2 and 9.	
<u>HKFRS 12 <i>Disclosure of Interests in Other Entities</i> (Basis for Conclusions)</u>	Replace the cover page and pages 2 and 15 with revised cover page and pages 2 and 15.	
<u>HKFRS 13 <i>Fair Value Measurement</i></u>	Replace the full set of HKFRS 13 (revised November 2016) with HKFRS 13 (revised September 2018).	
<u>HKFRS 13 <i>Fair Value Measurement</i> (Basis for Conclusions)</u>	Replace the full set of Basis for Conclusions (revised November 2016) with Basis for Conclusions (revised September 2018).	
<u>HKFRS 15 <i>Revenue from Contracts with Customers</i></u>	Replace the full set of HKFRS 15 (revised June 2016) with HKFRS 15 (revised September 2018).	
<i>Annual Improvements to HKFRSs 2014-2016 Cycle</i>	Discard the full set of <i>Annual Improvements to HKFRSs 2014-2016 Cycle</i> .	

HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)

<u>HK(IFRIC)-Int 2 <i>Members' Shares in Co-operative Entities and Similar Instruments</i></u>	Replace the full set of HK(IFRIC)-Int 2 (revised February 2014) with HK(IFRIC)-Int 2 (revised September 2018).

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<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>HK(IFRIC)-Int 4 Determining whether an Arrangement contains a Lease</u>	Replace the cover page and pages 2 and 13 with revised cover page and pages 2 and 13.	Refer page 1.
<u>HK(IFRIC)-Int 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds</u>	Replace the full set of HK(IFRIC)-Int 5 (revised February 2014) with HK(IFRIC)-Int 5 (revised September 2018).	
<u>HK(IFRIC)-Int 10 Interim Financial Reporting and Impairment</u>	Replace the full set of HK(IFRIC)-Int 10 (revised July 2012) with HK(IFRIC)-Int 10 (revised September 2018).	
<u>HK(IFRIC)-Int 12 Service Concession Arrangements</u>	Replace the cover page and pages 2, 4, 6-8, 8A, 14-15, 15A, 16, 18-19, 21-23, 27, 30-34 and 36 with revised cover page and pages 2, 4, 6-8, 8A, 14-15, 15A, 16, 18-19, 21-23, 27, 30-34 and 36.	
<u>HK(IFRIC)-Int 13 Customer Loyalty Programmes</u>	Replace the cover page with revised cover page.	
<u>HK(IFRIC)-Int 15 Agreements for the Construction of Real Estate</u>	Replace the cover page with revised cover page.	
<u>HK(IFRIC)-Int 16 Hedges of a Net Investment in a Foreign Operation</u>	Replace the full set of HK(IFRIC)-Int 16 (revised May 2014) with HK(IFRIC)-Int 16 (revised September 2018).	
<u>HK(IFRIC)-Int 17 Distributions of Non-cash Assets to Owners</u>	Replace the cover page and pages 2, 12-13, 13A and 14-16 with revised cover page and pages 2, 12-13, 13A and 14-16.	
<u>HK(IFRIC)-Int 18 Transfers of Assets from Customers</u>	Replace the cover page with revised cover page.	
<u>HK(IFRIC)-Int 19 Extinguishing Financial Liabilities with Equity Instruments</u>	Replace the full set of HK(IFRIC)-Int 19 (revised May 2014) with HK(IFRIC)-Int 19 (revised September 2018).	
<u>HK(IFRIC)-Int 22 Foreign Currency Transactions and Advance Consideration</u>	Replace the cover page and pages 2-3, 5 and 7 with revised cover page and pages 2-3, 5 and 7.	

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<u>HK(SIC)-Int 31 <i>Revenue – Barter Transactions Involving Advertising Services</i></u>	Replace the cover page with revised cover page.	
<u>HK(SIC)-Int 32 <i>Intangible Assets – Web Site Costs</i></u>	Replace the cover page, pages 2-4 and 7 with revised cover page and pages 2-4 and 7.	



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(Updated to September 2018)

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HKAS 1 (Revised)
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beginning on or after 1 January 2009

Hong Kong Accounting Standard 1 (Revised)

Presentation of Financial Statements



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Accounting Standard 1 *Presentation of Financial Statements* (HKAS 1) is set out in paragraphs 1–140 and Appendix A. All the paragraphs have equal authority. HKAS 1 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

This revised Standard was issued in December 2007 and revised in September 2018. ~~December 2016~~. It supersedes HKAS 1, issued in 2004, as amended in 2005.

Introduction

- IN1 Hong Kong Accounting Standard 1 *Presentation of Financial Statements* (HKAS 1) replaces HKAS 1 *Presentation of Financial Statements* (issued in 2004) as amended in 2005. HKAS 1 sets overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

Reasons for revising HKAS 1

- IN2 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) revising HKAS 1 is to maintain international convergence arising from the revision of IAS 1 *Presentation of Financial Statements* by the International Accounting Standards Board (IASB). The HKICPA supported the reasons for revising IAS 1 of the IASB.

The main objective of the IASB in revising IAS 1 was to aggregate information in the financial statements on the basis of shared characteristics. With this in mind, the IASB considered it useful to separate changes in equity (net assets) of an entity during a period arising from transactions with owners in their capacity as owners from other changes in equity. Consequently, the IASB decided that all owner changes in equity should be presented in the statement of changes in equity, separately from non-owner changes in equity.

- IN3 In its review, the IASB also considered FASB Statement No. 130 *Reporting Comprehensive Income* (SFAS 130) issued in 1997. The requirements in IAS 1 regarding the presentation of the statement of comprehensive income are similar to those in SFAS 130; however, some differences remain and those are identified in paragraph BC106 of the Basis for Conclusions.
- IN4 In addition, the IASB's intention in revising IAS 1 was to improve and reorder sections of IAS 1 to make it easier to read. The IASB's objective was not to reconsider all the requirements of IAS 1.

Main features of HKAS 1

- IN5 HKAS 1 affects the presentation of owner changes in equity and of comprehensive income. It does not change the recognition, measurement or disclosure of specific transactions and other events required by other HKFRSs.
- IN6 HKAS 1 requires an entity to present, in a statement of changes in equity, all owner changes in equity. All non-owner changes in equity (ie comprehensive income) are required to be presented in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income). Components of comprehensive income are not permitted to be presented in the statement of changes in equity.
- IN7 HKAS 1 requires an entity to present a statement of financial position as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies an accounting policy retrospectively or makes a retrospective restatement, as defined in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, or when the entity reclassifies items in the financial statements.
- IN8 HKAS 1 requires an entity to disclose reclassification adjustments and income tax relating to each component of other comprehensive income. Reclassification adjustments are the amounts reclassified to profit or loss in the current period that were previously recognised in other comprehensive income.

- IN9 HKAS 1 requires the presentation of dividends recognised as distributions to owners and related amounts per share in the statement of changes in equity or in the notes. Dividends are distributions to owners in their capacity as owners and the statement of changes in equity presents all owner changes in equity.

Changes from previous requirements

- IN10 The main changes from the previous version of HKAS 1 are described below.

A complete set of financial statements

- IN11 The previous version of HKAS 1 used the titles 'balance sheet' and 'cash flow statement' to describe two of the statements within a complete set of financial statements. HKAS 1 uses 'statement of financial position' and 'statement of cash flows' for those statements. The new titles reflect more closely the function of those statements, as described in the *Framework*^{*} (see paragraphs BC14–BC21 of the Basis for Conclusions).
- IN12 HKAS 1 requires an entity to disclose comparative information in respect of the previous period, ie to disclose as a minimum two of each of the statements and related notes. It introduces a requirement to include in a complete set of financial statements a statement of financial position as at the beginning of the earliest comparative period whenever the entity retrospectively applies an accounting policy or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. The purpose is to provide information that is useful in analysing an entity's financial statements (see paragraphs BC31 and BC32 of the Basis for Conclusions).

Reporting owner changes in equity and comprehensive income

- IN13 The previous version of HKAS 1 required the presentation of an income statement that included items of income and expense recognised in profit or loss. It required items of income and expense not recognised in profit or loss to be presented in the statement of changes in equity, together with owner changes in equity. It also labelled the statement of changes in equity comprising profit or loss, other items of income and expense and the effects of changes in accounting policies and correction of errors as 'statement of recognised income and expense'. HKAS 1 now requires:
- (a) all changes in equity arising from transactions with owners in their capacity as owners (ie owner changes in equity) to be presented separately from non-owner changes in equity. An entity is not permitted to present components of comprehensive income (ie non-owner changes in equity) in the statement of changes in equity. The purpose is to provide better information by aggregating items with shared characteristics and separating items with different characteristics (see paragraphs BC37 and BC38 of the Basis for Conclusions).
 - (b) income and expenses to be presented in one statement (a statement of comprehensive income) or in two statements (a separate income statement and a statement of comprehensive income), separately from owner changes in equity (see paragraphs BC49–BC54 of the Basis for Conclusions).
 - (c) components of other comprehensive income to be displayed in the statement of comprehensive income.
 - (d) total comprehensive income to be presented in the financial statements.

^{*} In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

Other comprehensive income—reclassification adjustments and related tax effects

- IN14 HKAS 1 requires an entity to disclose income tax relating to each component of other comprehensive income. The previous version of HKAS 1 did not include such a requirement. The purpose is to provide users with tax information relating to these components because the components often have tax rates different from those applied to profit or loss (see paragraphs BC65–BC68 of the Basis for Conclusions).
- IN15 HKAS 1 also requires an entity to disclose reclassification adjustments relating to components of other comprehensive income. Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in previous periods. The purpose is to provide users with information to assess the effect of such reclassifications on profit or loss (see paragraphs BC69–BC73 of the Basis for Conclusions).

Presentation of dividends

- IN16 The previous version of HKAS 1 permitted disclosure of the amount of dividends recognised as distributions to equity holders (now referred to as ‘owners’) and the related amount per share in the income statement, in the statement of changes in equity or in the notes. HKAS 1 requires dividends recognised as distributions to owners and related amounts per share to be presented in the statement of changes in equity or in the notes. The presentation of such disclosures in the statement of comprehensive income is not permitted (see paragraph BC75 of the Basis for Conclusions). The purpose is to ensure that owner changes in equity (in this case, distributions to owners in the form of dividends) are presented separately from non-owner changes in equity (presented in the statement of comprehensive income).

Presentation of items of other comprehensive income

- IN17 In July 2011 the HKICPA issued *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1). The amendments improved the consistency and clarity of the presentation of items of other comprehensive income (OCI). The amendments also highlighted the importance on presenting profit or loss and OCI together and with equal prominence. As explained in paragraph IN13, in 2007 HKAS 1 was amended to require profit or loss and OCI to be presented together. The amendments issued in July 2011 retained that requirement, but focused on improving how items of OCI are presented.
- IN18 The main change resulting from the amendments was a requirement for entities to group items presented in OCI on the basis of whether they are potentially reclassifiable to profit or loss subsequently (reclassification adjustments). The amendments did not address which items are presented in OCI.
- IN19 The amendments did not change the option to present items of OCI either before tax or net of tax. However, if the items are presented before tax then the tax related to each of the two groups of OCI items (those that might be reclassified and those that will not be reclassified) must be shown separately.

Hong Kong Accounting Standard 1

Presentation of Financial Statements

Objective

- 1 This Standard prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

Scope

- 2 **An entity shall apply this Standard in preparing and presenting general purpose financial statements in accordance with Hong Kong Financial Reporting Standards (HKFRSs).**
- 3 Other HKFRSs set out the recognition, measurement and disclosure requirements for specific transactions and other events.
- 4 This Standard does not apply to the structure and content of condensed interim financial statements prepared in accordance with HKAS 34 *Interim Financial Reporting*. However, paragraphs 15–35 apply to such financial statements. This Standard applies equally to all entities, including those that present consolidated financial statements in accordance with HKFRS 10 *Consolidated Financial Statements* and those that present separate financial statements in accordance with HKAS 27 *Separate Financial Statements*.
- 5 This Standard uses terminology that is suitable for profit-oriented entities, including public sector business entities. If entities with not-for-profit activities in the private sector or the public sector apply this Standard, they may need to amend the descriptions used for particular line items in the financial statements and for the financial statements themselves.
- 6 Similarly, entities that do not have equity as defined in HKAS 32 *Financial Instruments: Presentation* (eg some mutual funds) and entities whose share capital is not equity (eg some co-operative entities) may need to adapt the financial statement presentation of members' or unitholders' interests.

Definitions

- 7 **The following terms are used in this Standard with the meanings specified:**

General purpose financial statements (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Impracticable Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

Hong Kong Financial Reporting Standards (HKFRSs) are Standards and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). They comprise:

- (a) Hong Kong Financial Reporting Standards;
- (b) Hong Kong Accounting Standards; and
- (c) Interpretations.

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

Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25* that ‘users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.’ Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Notes contain information in addition to that presented in the statement of financial position, statement(s) of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements.

Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRSs.

The components of other comprehensive income include:

- (a) changes in revaluation surplus (see HKAS 16 *Property, Plant and Equipment* and HKAS 38 *Intangible Assets*);
- (b) remeasurements of defined benefit plans (see HKAS 19 *Employee Benefits*);
- (c) gains and losses arising from translating the financial statements of a foreign operation (see HKAS 21 *The Effects of Changes in Foreign Exchange Rates*);
- ~~(d) gains and losses on remeasuring available-for-sale financial assets (see HKAS 39 *Financial Instruments: Recognition and Measurement*);~~
- (d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 *Financial Instruments*;
- (da) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9.
- (e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 (see Chapter 6 of HKFRS 9); ~~(see HKAS 39).~~
- (f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of HKFRS 9);
- (g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging

* In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraph 25 was superseded by Chapter 3 of the *Conceptual Framework*.

instrument only the changes in the intrinsic value (see Chapter 6 of HKFRS 9); and

- (h) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see Chapter 6 of HKFRS 9).

Owners are holders of instruments classified as equity.

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

Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners.

Total comprehensive income comprises all components of 'profit or loss' and of 'other comprehensive income'.

- 8 Although this Standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss.
- 8A The following terms are described in HKAS 32 *Financial Instruments: Presentation* and are used in this Standard with the meaning specified in HKAS 32:
- (a) puttable financial instrument classified as an equity instrument (described in paragraphs 16A and 16B of HKAS 32)
 - (b) an instrument that imposes on the entity an obligation to deliver to another party a pro_rata share of the net assets of the entity only on liquidation and is classified as an equity instrument (described in paragraphs 16C and 16D of HKAS 32).

Financial statements

Purpose of financial statements

- 9 Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:
- (a) assets;
 - (b) liabilities;
 - (c) equity;
 - (d) income and expenses, including gains and losses;

- (e) contributions by and distributions to owners in their capacity as owners; and
- (f) cash flows.

This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

Complete set of financial statements

10 A complete set of financial statements comprises:

- (a) a statement of financial position as at the end of the period;
- (b) a statement of profit or loss and other comprehensive income for the period;
- (c) a statement of changes in equity for the period;
- (d) a statement of cash flows for the period;
- (e) notes, comprising significant accounting policies and other explanatory information;
- (ea) comparative information in respect of the preceding period as specified in paragraphs 38 and 38A; and
- (f) a statement of financial position as at the beginning of the preceding 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 in accordance with paragraphs 40A - 40D.

An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

10A An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section. An entity may present the profit or loss section in a separate statement of profit or loss. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.

11 An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

12 [Deleted]

13 Many entities present, outside the financial statements, a financial review by management that describes and explains the main features of the entity's financial performance and financial position, and the principal uncertainties it faces. Such a report may include a review of:

- (a) the main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and the entity's policy for investment to maintain and enhance financial performance, including its dividend policy;
- (b) the entity's sources of funding and its targeted ratio of liabilities to equity; and

- (c) the entity's resources not recognised in the statement of financial position in accordance with HKFRSs.
- 14 Many entities also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group. Reports and statements presented outside financial statements are outside the scope of HKFRSs.

General features

True and fair view and compliance with HKFRSs

- 15 **Financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity. True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.^{*} The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a true and fair view.**
- 16 **An entity whose financial statements comply with HKFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with HKFRSs unless they comply with all the requirements of HKFRSs.**
- 17 In virtually all circumstances, an entity achieves a true and fair view by compliance with applicable HKFRSs. A true and fair view also requires an entity:
- (a) to select and apply accounting policies in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. HKAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an HKFRS that specifically applies to an item.
 - (b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.
 - (c) to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.
- 18 **An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.**
- 19 **In the extremely rare circumstances in which management concludes that compliance with a requirement in ~~an~~ a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.**

^{*} Paragraphs 15-24 contain references to the objective of financial statements set out in the *Framework* [*for the Preparation and Presentation of Financial Statements*]. In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*, which replaced the objective of financial statements with the objective of general purpose financial reporting: see Chapter 1 of the *Conceptual Framework*.

- 20 When an entity departs from a requirement of ~~an~~a HKFRS in accordance with paragraph 19, it shall disclose:
- (a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
 - (b) that it has complied with applicable HKFRSs, except that it has departed from a particular requirement to achieve a true and fair view;
 - (c) the title of the HKFRS from which the entity has departed, the nature of the departure, including the treatment that the HKFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Framework*, and the treatment adopted; and
 - (d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.
- 21 When an entity has departed from a requirement of ~~an~~a HKFRS in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, it shall make the disclosures set out in paragraph 20(c) and (d).
- 22 Paragraph 21 applies, for example, when an entity departed in a prior period from a requirement in ~~an~~a HKFRS for the measurement of assets or liabilities and that departure affects the measurement of changes in assets and liabilities recognised in the current period's financial statements.
- 23 In the extremely rare circumstances in which management concludes that compliance with a requirement in ~~an~~a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:
- (a) the title of the HKFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the *Framework*; and
 - (b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a true and fair view.
- 24 For the purpose of paragraphs 19–23, an item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements. When assessing whether complying with a specific requirement in ~~an~~a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, management considers:
- (a) why the objective of financial statements is not achieved in the particular circumstances; and
 - (b) how the entity's circumstances differ from those of other entities that comply with the requirement. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the *Framework*.

Going concern

- 25** When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.
- 26** In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

Accrual basis of accounting

- 27** An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.
- 28** When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the *Framework*.*

Materiality and aggregation

- 29** An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.
- 30** Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.
- 30A** When applying this and other HKFRSs an entity shall decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which include the notes. An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.
- 31** Some HKFRSs specify information that is required to be included in the financial statements, which include the notes. An entity need not provide a specific disclosure required by a HKFRS if the information resulting from that disclosure is not material. This is the case even if the HKFRS contains a list of specific requirements or describes them as minimum requirements. An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in HKFRS is insufficient to

* replaced by the *Conceptual Framework* in October 2010.

enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Offsetting

- 32 An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an HKFRS.**
- 33 An entity reports separately both assets and liabilities, and income and expenses. Offsetting in the statement(s) of profit or loss and other comprehensive income or financial position, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. Measuring assets net of valuation allowances—for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting.
- 34 HKFRS 15 Revenue from Contracts with Customers ~~HKAS 18 Revenue defines revenue and requires an entity to measure revenue from contracts with customers at the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services. For example, the amount of revenue recognised reflects fair value of the consideration received or receivable, taking into account the amount of any trade discounts and volume rebates the entity allows. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. For example:~~
- (a) an entity presents gains and losses on the disposal of non-current assets, including investments and operating assets, by deducting from the amount of consideration proceeds on disposal the carrying amount of the asset and related selling expenses; and
 - (b) an entity may net expenditure related to a provision that is recognised in accordance with *HKAS 37 Provisions, Contingent Liabilities and Contingent Assets* and reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) against the related reimbursement.
- 35 In addition, an entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material.

Frequency of reporting

- 36 An entity shall present a complete set of financial statements (including comparative information) at least annually. When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:**
- (a) the reason for using a longer or shorter period, and
 - (b) the fact that amounts presented in the financial statements are not entirely comparable.
- 37 Normally, an entity consistently prepares financial statements for a one-year period. However, for practical reasons, some entities prefer to report, for example, for a 52-week period. This Standard does not preclude this practice.

Comparative information*Minimum comparative information*

- 38** Except when HKFRSs permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.
- 38A** An entity shall present, as a minimum, two statements of financial position, two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity, and related notes.
- 38B** In some cases, narrative information provided in the financial statements for the preceding period(s) continues to be relevant in the current period. For example, an entity discloses in the current period details of a legal dispute, the outcome of which was uncertain at the end of the preceding period and is yet to be resolved. Users may benefit from the disclosure of information that the uncertainty existed at the end of the preceding period and from the disclosure of information about the steps that have been taken during the period to resolve the uncertainty.

Additional comparative information

- 38C** An entity may present comparative information in addition to the minimum comparative financial statements required by HKFRSs, as long as that information is prepared in accordance with HKFRSs. This comparative information may consist of one or more statements referred to in paragraph 10, but need not comprise a complete set of financial statements. When this is the case, the entity shall present related note information for those additional statements.
- 38D** For example, an entity may present a third statement of profit or loss and other comprehensive income (thereby presenting the current period, the preceding period and one additional comparative period). However, the entity is not required to present a third statement of financial position, a third statement of cash flows or a third statement of changes in equity (ie an additional financial statement comparative). The entity is required to present, in the notes to the financial statements, the comparative information related to that additional statement of profit or loss and other comprehensive income.

~~39-~~ [Deleted]

~~40~~

~~40~~ [Deleted]

Change in accounting policy, retrospective restatement or reclassification

- 40A** An entity shall present a third statement of financial position as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38A if:
- (a) it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
 - (b) the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period.

- 40B In the circumstances described in paragraph 40A, an entity shall present three statements of financial position as at:
- (a) the end of the current period;
 - (b) the end of the preceding period; and
 - (c) the beginning of the preceding period.
- 40C When an entity is required to present an additional statement of financial position in accordance with paragraph 40A, it must disclose the information required by paragraphs 41–44 and HKAS 8. However, it need not present the related notes to the opening statement of financial position as at the beginning of the preceding period.
- 40D The date of that opening statement of financial position shall be as at the beginning of the preceding period regardless of whether an entity's financial statements present comparative information for earlier periods (as permitted in paragraph 38C).
- 41 If an entity changes the presentation or classification of items in its financial statements, it shall reclassify comparative amounts unless reclassification is impracticable. When an entity reclassifies comparative amounts, it shall disclose (including as at the beginning of the preceding period):**
- (a) the nature of the reclassification;
 - (b) the amount of each item or class of items that is reclassified; and
 - (c) the reason for the reclassification.
- 42 When it is impracticable to reclassify comparative amounts, an entity shall disclose:**
- (a) the reason for not reclassifying the amounts, and
 - (b) the nature of the adjustments that would have been made if the amounts had been reclassified.
- 43 Enhancing the inter-period comparability of information assists users in making economic decisions, especially by allowing the assessment of trends in financial information for predictive purposes. In some circumstances, it is impracticable to reclassify comparative information for a particular prior period to achieve comparability with the current period. For example, an entity may not have collected data in the prior period(s) in a way that allows reclassification, and it may be impracticable to recreate the information.
- 44 HKAS 8 sets out the adjustments to comparative information required when an entity changes an accounting policy or corrects an error.

Consistency of presentation

- 45 An entity shall retain the presentation and classification of items in the financial statements from one period to the next unless:**
- (a) it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in HKAS 8; or
 - (b) ~~an~~ a HKFRS requires a change in presentation.

- 46 For example, a significant acquisition or disposal, or a review of the presentation of the financial statements, might suggest that the financial statements need to be presented differently. An entity changes the presentation of its financial statements only if the changed presentation provides information that is reliable and more relevant to users of the financial statements and the revised structure is likely to continue, so that comparability is not impaired. When making such changes in presentation, an entity reclassifies its comparative information in accordance with paragraphs 41 and 42.

Structure and content

Introduction

- 47 This Standard requires particular disclosures in the statement of financial position or the statement(s) of profit ~~of~~ or loss and other comprehensive income, or in the statement of changes in equity and requires disclosure of other line items either in those statements or in the notes. HKAS 7 *Statement of Cash Flows* sets out requirements for the presentation of cash flow information.
- 48 This Standard sometimes uses the term 'disclosure' in a broad sense, encompassing items presented in the financial statements. Disclosures are also required by other HKFRSs. Unless specified to the contrary elsewhere in this Standard or in another HKFRS, such disclosures may be made in the financial statements.

Identification of the financial statements

- 49 **An entity shall clearly identify the financial statements and distinguish them from other information in the same published document.**
- 50 HKFRSs apply only to financial statements, and not necessarily to other information presented in an annual report, a regulatory filing, or another document. Therefore, it is important that users can distinguish information that is prepared using HKFRSs from other information that may be useful to users but is not the subject of those requirements.
- 51 **An entity shall clearly identify each financial statement and the notes. In addition, an entity shall display the following information prominently, and repeat it when necessary for the information presented to be understandable:**
- (a) **the name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period;**
 - (b) **whether the financial statements are of an individual entity or a group of entities;**
 - (c) **the date of the end of the reporting period or the period covered by the set of financial statements or notes;**
 - (d) **the presentation currency, as defined in HKAS 21; and**
 - (e) **the level of rounding used in presenting amounts in the financial statements.**
- 52 An entity meets the requirements in paragraph 51 by presenting appropriate headings for pages, statements, notes, columns and the like. Judgement is required in determining the best way of presenting such information. For example, when an entity presents the financial statements electronically, separate pages are not always used; an entity then presents the above items to ensure that the information included in the financial statements can be understood.

- 53 An entity often makes financial statements more understandable by presenting information in thousands or millions of units of the presentation currency. This is acceptable as long as the entity discloses the level of rounding and does not omit material information.

Statement of financial position

Information to be presented in the statement of financial position

- 54 The statement of financial position shall include line items that present the following amounts:

- (a) property, plant and equipment;
- (b) investment property;
- (c) intangible assets;
- (d) financial assets (excluding amounts shown under (e), (h) and (i));
- (e) investments accounted for using the equity method;
- (f) biological assets within the scope of HKAS 41 *Agriculture*;
- (g) inventories;
- (h) trade and other receivables;
- (i) cash and cash equivalents;
- (j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;
- (k) trade and other payables;
- (l) provisions;
- (m) financial liabilities (excluding amounts shown under (k) and (l));
- (n) liabilities and assets for current tax, as defined in HKAS 12 *Income Taxes*;
- (o) deferred tax liabilities and deferred tax assets, as defined in HKAS 12;
- (p) liabilities included in disposal groups classified as held for sale in accordance with HKFRS 5;
- (q) non-controlling interests, presented within equity; and
- (r) issued capital and reserves attributable to owners of the parent.

- 55 An entity shall present additional line items (including by disaggregating the line items listed in paragraph 54), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

- 55A When an entity presents subtotals in accordance with paragraph 55, those subtotals shall:

- (a) be comprised of line items made up of amounts recognised and measured in accordance with HKFRS;
 - (b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;
 - (c) be consistent from period to period, in accordance with paragraph 45; and
 - (d) not be displayed with more prominence than the subtotals and totals required in HKFRS for the statement of financial position.
- 56 When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).**
- 57** This Standard does not prescribe the order or format in which an entity presents items. Paragraph 54 simply lists items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position. In addition:
- (a) line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position; and
 - (b) the descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position. For example, a financial institution may amend the above descriptions to provide information that is relevant to the operations of a financial institution.
- 58** An entity makes the judgement about whether to present additional items separately on the basis of an assessment of:
- (a) the nature and liquidity of assets;
 - (b) the function of assets within the entity; and
 - (c) the amounts, nature and timing of liabilities.
- 59** The use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that an entity presents them as separate line items. For example, different classes of property, plant and equipment can be carried at cost or at revalued amounts in accordance with HKAS 16.

Current/non-current distinction

- 60 An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position in accordance with paragraphs 66–76 except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.**
- 61** Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:
- (a) no more than twelve months after the reporting period, and
 - (b) more than twelve months after the reporting period.

- 62 When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities in the statement of financial position provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period.
- 63 For some entities, such as financial institutions, a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and more relevant than a current/ non-current presentation because the entity does not supply goods or services within a clearly identifiable operating cycle.
- 64 In applying paragraph 60, an entity is permitted to present some of its assets and liabilities using a current/non-current classification and others in order of liquidity when this provides information that is reliable and more relevant. The need for a mixed basis of presentation might arise when an entity has diverse operations.
- 65 Information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. HKFRS 7 *Financial Instruments: Disclosures* requires disclosure of the maturity dates of financial assets and financial liabilities. Financial assets include trade and other receivables, and financial liabilities include trade and other payables. Information on the expected date of recovery of non-monetary assets such as inventories and expected date of settlement for liabilities such as provisions is also useful, whether assets and liabilities are classified as current or as non-current. For example, an entity discloses the amount of inventories that are expected to be recovered more than twelve months after the reporting period.

Current assets

- 66 **An entity shall classify an asset as current when:**
- (a) **it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;**
 - (b) **it holds the asset primarily for the purpose of trading;**
 - (c) **it expects to realise the asset within twelve months after the reporting period; or**
 - (d) **the asset is cash or a cash equivalent (as defined in HKAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.**

An entity shall classify all other assets as non-current.

- 67 This Standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.
- 68 The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of trading (examples include some financial assets that meet the definition of held for trading in HKFRS 9 ~~classified as held for trading in accordance with HKAS 39~~) and the current portion of non-current financial assets.

Current liabilities

69 An entity shall classify a liability as current when:

- (a) it expects to settle the liability in its normal operating cycle;**
- (b) it holds the liability primarily for the purpose of trading;**
- (c) the liability is due to be settled within twelve months after the reporting period; or**
- (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.**

An entity shall classify all other liabilities as non-current.

- 70** Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period. The same normal operating cycle applies to the classification of an entity's assets and liabilities. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.
- 71** Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading. Examples are some financial liabilities that meet the definition of held for trading in HKFRS 9 ~~classified as held for trading in accordance with HKAS 39~~, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities, subject to paragraphs 74 and 75.
- 72** An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:
- (a) the original term was for a period longer than twelve months, and**
 - (b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.**
- 73** If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.
- 74** When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

- 75 However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.
- 76 In respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting events in accordance with HKAS 10 *Events after the Reporting Period*:
- (a) refinancing on a long-term basis;
 - (b) rectification of a breach of a long-term loan arrangement; and
 - (c) the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period.

Information to be presented either in the statement of financial position or in the notes

- 77 **An entity shall disclose, either in the statement of financial position or in the notes, further subclassifications of the line items presented, classified in a manner appropriate to the entity's operations.**
- 78 The detail provided in subclassifications depends on the requirements of HKFRSs and on the size, nature and function of the amounts involved. An entity also uses the factors set out in paragraph 58 to decide the basis of subclassification. The disclosures vary for each item, for example:
- (a) items of property, plant and equipment are disaggregated into classes in accordance with HKAS 16;
 - (b) receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts;
 - (c) inventories are disaggregated, in accordance with HKAS 2 *Inventories*, into classifications such as merchandise, production supplies, materials, work in progress and finished goods;
 - (d) provisions are disaggregated into provisions for employee benefits and other items; and
 - (e) equity capital and reserves are disaggregated into various classes, such as paid-in capital, share premium and reserves.
- 79 **An entity shall disclose the following, either in the statement of financial position or the statement of changes in equity, or in the notes:**
- (a) **for each class of share capital:**
 - (i) **the number of shares authorised;**
 - (ii) **the number of shares issued and fully paid, and issued but not fully paid;**
 - (iii) **par value per share, or that the shares have no par value;**
 - (iv) **a reconciliation of the number of shares outstanding at the beginning and at the end of the period;**

- (v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
 - (vi) shares in the entity held by the entity or by its subsidiaries or associates; and
 - (vii) shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
- (b) a description of the nature and purpose of each reserve within equity.
- 80** An entity without share capital, such as a partnership or trust, shall disclose information equivalent to that required by paragraph 79(a), showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest.
- 80A** If an entity has reclassified
- (a) a puttable financial instrument classified as an equity instrument, or
 - (b) an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and is classified as an equity instrument

between financial liabilities and equity, it shall disclose the amount reclassified into and out of each category (financial liabilities or equity), and the timing and reason for that reclassification.

Statement of profit or loss and other comprehensive income

- 81** [Deleted]
- 81A** The statement of profit or loss and other comprehensive income (statement of comprehensive income) shall present, in addition to the profit or loss and other comprehensive income sections:
- (a) profit or loss;
 - (b) total other comprehensive income;
 - (c) comprehensive income for the period, being the total of profit or loss and other comprehensive income.
- If an entity presents a separate statement of profit or loss it does not present the profit or loss section in the statement presenting comprehensive income.
- 81B** An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:
- (a) profit or loss for the period attributable to:
 - (i) non-controlling interests, and
 - (ii) owners of the parent.
 - (b) comprehensive income for the period attributable to:
 - (i) non-controlling interests, and

- (ii) owners of the parent.

If an entity presents profit or loss in a separate statement it shall present (a) in that statement.

Information to be presented in the profit or loss section or the statement of profit or loss

- 82 In addition to items required by other HKFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:
- (a) revenue, presenting separately interest revenue calculated using the effective interest method;
 - (aa) gains and losses arising from the derecognition of financial assets measured at amortised cost;
 - (b) finance costs;
 - (ba) impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of HKFRS 9;
 - (c) share of the profit or loss of associates and joint ventures accounted for using the equity method;
 - (ca) if a financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous amortised cost of the financial asset and its fair value at the reclassification date (as defined in HKFRS 9);
 - (cb) if a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss;
 - (d) tax expense;
 - (e) [deleted]
 - (ea) a single amount for the total of discontinued operations (see HKFRS 5).
 - (f)-(i) [deleted]

Information to be presented in the other comprehensive income section

- 82A** The other comprehensive income section shall present line items for the amounts for the period of:
- (a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other HKFRSs:
 - (i) will not be reclassified subsequently to profit or loss; and
 - (ii) will be reclassified subsequently to profit or loss when specific conditions are met.
 - (b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other HKFRSs:
 - (i) will not be reclassified subsequently to profit or loss; and
 - (ii) will be reclassified subsequently to profit or loss when specific conditions are met.
- 83-84** [Deleted]
- 85** An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.
- 85A** When an entity presents subtotals in accordance with paragraph 85, those subtotals shall:
- (a) be comprised of line items made up of amounts recognised and measured in accordance with HKFRS;
 - (b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;
 - (c) be consistent from period to period, in accordance with paragraph 45; and
 - (d) not be displayed with more prominence than the subtotals and totals required in HKFRS for the statement(s) presenting profit or loss and other comprehensive income.
- 85B** An entity shall present the line items in the statement(s) presenting profit or loss and other comprehensive income that reconcile any subtotals presented in accordance with paragraph 85 with the subtotals or totals required in HKFRS for such statement(s).
- 86** Because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity includes additional line items in the statement(s) presenting profit or loss and other comprehensive income and it amends the descriptions used and the ordering of items when this is necessary to explain the elements of financial performance. An entity considers factors including materiality and the nature and function of the items of income and expense. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. An entity does not offset income and expense items unless the criteria in paragraph 32 are met.

- 87 An entity shall not present any items of income or expense as extraordinary items, in the statement(s) presenting profit or loss and other comprehensive income or in the notes.**

Profit or loss for the period

- 88 An entity shall recognise all items of income and expense in a period in profit or loss unless an HKFRS requires or permits otherwise.**

- 89 Some HKFRSs specify circumstances when an entity recognises particular items outside profit or loss in the current period. HKAS 8 specifies two such circumstances: the correction of errors and the effect of changes in accounting policies. Other HKFRSs require or permit components of other comprehensive income that meet the *Framework*^{*} definition of income or expense to be excluded from profit or loss (see paragraph 7).

Other comprehensive income for the period

- 90 An entity shall disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit or loss and other comprehensive income or in the notes.**

- 91 An entity may present items of other comprehensive income either:

- (a) net of related tax effects, or
- (b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.

If an entity elects alternative (b), it shall allocate the tax between the items that might be reclassified subsequently to the profit or loss section and those that will not be reclassified subsequently to the profit or loss section.

- 92 An entity shall disclose reclassification adjustments relating to components of other comprehensive income.**

- 93 Other HKFRSs specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments. A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. ~~For example, gains realised on the disposal of available-for-sale financial assets are included in profit or loss of the current period.~~ These amounts may have been recognised in other comprehensive income as unrealised gains in the current or previous periods. Those unrealised gains must be deducted from other comprehensive income in the period in which the realised gains are reclassified to profit or loss to avoid including them in total comprehensive income twice.

- 94 An entity may present reclassification adjustments in the statement(s) of profit or loss and other comprehensive income or in the notes. An entity presenting reclassification adjustments in the notes presents the items of other comprehensive income after any related reclassification adjustments.

* In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

95 ~~Reclassification adjustments arise, for example, on disposal of a foreign operation (see HKAS 21), and when some hedged forecast cash flows affect profit or loss (see paragraph 6.5.11(d) of HKFRS 9 in relation to cash flow hedges).—on derecognition of available for sale financial assets (see HKAS 39) and when a hedged forecast transaction affects profit or loss (see paragraph 100 of HKAS 39 in relation to cash flow hedges).~~

96 Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with HKAS 16 or HKAS 38 or on remeasurements of defined benefit plans recognised in accordance with HKAS 19. These components are recognised in other comprehensive income and are not reclassified to profit or loss in subsequent periods. Changes in revaluation surplus may be transferred to retained earnings in subsequent periods as the asset is used or when it is derecognised (see HKAS 16 and HKAS 38). In accordance with HKFRS 9, reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument) result in amounts that are removed from the cash flow hedge reserve or a separate component of equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability. These amounts are directly transferred to assets or liabilities.

Information to be presented in the statement(s) of profit or loss and other comprehensive income or in the notes

97 When items of income or expense are material, an entity shall disclose their nature and amount separately.

98 Circumstances that would give rise to the separate disclosure of items of income and expense include:

- (a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
- (b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- (c) disposals of items of property, plant and equipment;
- (d) disposals of investments;
- (e) discontinued operations;
- (f) litigation settlements; and
- (g) other reversals of provisions.

99 An entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.

100 Entities are encouraged to present the analysis in paragraph 99 in the statement(s) presenting profit or loss and other comprehensive income.

101 Expenses are subclassified to highlight components of financial performance that may differ in terms of frequency, potential for gain or loss and predictability. This analysis is provided in one of two forms.

102 The first form of analysis is the 'nature of expense' method. An entity aggregates expenses within profit or loss according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method may be simple to

apply because no allocations of expenses to functional classifications are necessary. An example of a classification using the nature of expense method is as follows:

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

- 103 The second form of analysis is the 'function of expense' or 'cost of sales' method and classifies expenses according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgement. An example of a classification using the function of expense method is as follows:

Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Profit before tax	X

- 104 **An entity classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense.**

- 105 The choice between the function of expense method and the nature of expense method depends on historical and industry factors and the nature of the entity. Both methods provide an indication of those costs that might vary, directly or indirectly, with the level of sales or production of the entity. Because each method of presentation has merit for different types of entities, this Standard requires management to select the presentation that is reliable and more relevant. However, because information on the nature of expenses is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used. In paragraph 104, 'employee benefits' has the same meaning as in HKAS 19.

Statement of changes in equity

Information to be presented in the statement of changes in equity

- 106** An entity shall present a statement of changes in equity as required by paragraph 10. The statement of changes in equity includes the following information:
- (a) total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;
 - (b) for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with HKAS 8; and
 - (c) [deleted]
 - (d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:
 - (i) profit or loss;
 - (ii) other comprehensive income; and
 - (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

Information to be presented in the statement of changes in equity or in the notes

- 106A** For each component of equity an entity shall present, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item (see paragraph 106(d)(ii)).
- 107** An entity shall present, either in the statement of changes in equity or in the notes, the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share.
- 108** In paragraph 106, the components of equity include, for example, each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings.
- 109** Changes in an entity's equity between the beginning and the end of the reporting period reflect the increase or decrease in its net assets during the period. Except for changes resulting from transactions with owners in their capacity as owners (such as equity contributions, reacquisitions of the entity's own equity instruments and dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expense, including gains and losses, generated by the entity's activities during that period.
- 110** HKAS 8 requires retrospective adjustments to effect changes in accounting policies, to the extent practicable, except when the transition provisions in another HKFRS require otherwise. HKAS 8 also requires restatements to correct errors to be made retrospectively, to the extent practicable. Retrospective adjustments and retrospective restatements are not changes in equity but they are adjustments to the opening balance of retained earnings, except when ~~an~~ a HKFRS requires retrospective adjustment of another component of equity. Paragraph 106(b) requires disclosure in the statement of changes in equity of the total adjustment to each component of equity resulting from changes in

accounting policies and, separately, from corrections of errors. These adjustments are disclosed for each prior period and the beginning of the period.

Statement of cash flows

- 111 Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. HKAS 7 sets out requirements for the presentation and disclosure of cash flow information.

Notes

Structure

- 112 The notes shall:
- (a) present information about the basis of preparation of the financial statements and the specific accounting policies used in accordance with paragraphs 117–124;
 - (b) disclose the information required by HKFRSs that is not presented elsewhere in the financial statements; and
 - (c) provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.
- 113 An entity shall, as far as practicable, present notes in a systematic manner. In determining a systematic manner, the entity shall consider the effect on the understandability and comparability of its financial statements. An entity shall cross-reference each item in the statements of financial position and in the statement(s) of profit or loss and other comprehensive income, and in the statements of changes in equity and of cash flows to any related information in the notes.
- 114 Examples of systematic ordering or grouping of the notes include:
- (a) giving prominence to the areas of its activities that the entity considers to be most relevant to an understanding of its financial performance and financial position, such as grouping together information about particular operating activities;
 - (b) grouping together information about items measured similarly such as assets measured at fair value; or
 - (c) following the order of the line items in the statement(s) of profit or loss and other comprehensive income and the statement of financial position, such as:
 - (i) statement of compliance with HKFRSs (see paragraph 16);
 - (ii) significant accounting policies applied (see paragraph 117);
 - (iii) supporting information for items presented in the statements of financial position and in the statement(s) of profit or loss and other comprehensive income, and in the statements of changes in equity and of cash flows, in the order in which each statement and each line item is presented; and
 - (iv) other disclosures, including:
 - (1) contingent liabilities (see HKAS 37) and unrecognised contractual commitments; and
 - (2) non-financial disclosures, eg the entity's financial risk management objectives and policies (see HKFRS 7).

115 [Deleted]

116 An entity may present notes providing information about the basis of preparation of the financial statements and specific accounting policies as a separate section of the financial statements.

Disclosure of accounting policies

117 An entity shall disclose its significant accounting policies comprising:

- (a) the measurement basis (or bases) used in preparing the financial statements, and**
- (b) the other accounting policies used that are relevant to an understanding of the financial statements.**

118 It is important for an entity to inform users of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which an entity prepares the financial statements significantly affects users' analysis. When an entity uses more than one measurement basis in the financial statements, for example when particular classes of assets are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.

119 In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position. Each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in HKFRSs. An example is disclosure of whether an entity applies the fair value or cost model to its investment property (see HKAS 40 *Investment Property*). Some HKFRSs specifically require disclosure of particular accounting policies, including choices made by management between different policies they allow. For example, HKAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment.

120 [Deleted]

121 An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material. It is also appropriate to disclose each significant accounting policy that is not specifically required by HKFRSs but the entity selects and applies in accordance with HKAS 8.

122 An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

123 In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements. For example, management makes judgements in determining:

- (a) ~~[deleted] whether financial assets are held-to-maturity investments;~~
- (b) when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities; ~~and~~

- (c) whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and-
- (d) whether the contractual terms of a financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

124 Some of the disclosures made in accordance with paragraph 122 are required by other HKFRSs. For example, HKFRS 12 *Disclosure of Interests in Other Entities* requires an entity to disclose the judgements it has made in determining whether it controls another entity. HKAS 40 requires disclosure of the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of the property is difficult.

Sources of estimation uncertainty

125 An entity shall disclose information about 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. In respect of those assets and liabilities, the notes shall include details of:

- (a) their nature, and**
- (b) their carrying amount as at the end of the reporting period.**

126 Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. For example, in the absence of recently observed market prices, future-oriented estimates are necessary to measure the recoverable amount of classes of property, plant and equipment, the effect of technological obsolescence on inventories, provisions subject to the future outcome of litigation in progress, and long-term employee benefit liabilities such as pension obligations. These estimates involve assumptions about such items as the risk adjustment to cash flows or discount rates, future changes in salaries and future changes in prices affecting other costs.

127 The assumptions and other sources of estimation uncertainty disclosed in accordance with paragraph 125 relate to the estimates that require management's most difficult, subjective or complex judgements. As the number of variables and assumptions affecting the possible future resolution of the uncertainties increases, those judgements become more subjective and complex, and the potential for a consequential material adjustment to the carrying amounts of assets and liabilities normally increases accordingly.

128 The disclosures in paragraph 125 are not required for assets and liabilities with a significant risk that their carrying amounts might change materially within the next financial year if, at the end of the reporting period, they are measured at fair value based on a quoted price in an active market for an identical asset or liability. Such fair values might change materially within the next financial year but these changes would not arise from assumptions or other sources of estimation uncertainty at the end of the reporting period.

129 An entity presents the disclosures in paragraph 125 in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:

- (a) the nature of the assumption or other estimation uncertainty;
- (b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

- (c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
 - (d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.
- 130 This Standard does not require an entity to disclose budget information or forecasts in making the disclosures in paragraph 125.
- 131 Sometimes it is impracticable to disclose the extent of the possible effects of an assumption or another source of estimation uncertainty at the end of the reporting period. In such cases, the entity discloses 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. In all cases, the entity discloses the nature and carrying amount of the specific asset or liability (or class of assets or liabilities) affected by the assumption.
- 132 The disclosures in paragraph 122 of particular judgements that management made in the process of applying the entity's accounting policies do not relate to the disclosures of sources of estimation uncertainty in paragraph 125.
- 133 Other HKFRSs require the disclosure of some of the assumptions that would otherwise be required in accordance with paragraph 125. For example, HKAS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of provisions. HKFRS 13 *Fair Value Measurement* requires disclosure of significant assumptions (including the valuation technique(s) and inputs) the entity uses when measuring the fair values of assets and liabilities that are carried at fair value.

Capital

- 134 An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.**
- 135 To comply with paragraph 134, the entity discloses the following:
- (a) qualitative information about its objectives, policies and processes for managing capital, including:
 - (i) a description of what it manages as capital;
 - (ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
 - (iii) how it is meeting its objectives for managing capital.
 - (b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (eg some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (eg components arising from cash flow hedges).
 - (c) any changes in (a) and (b) from the previous period.
 - (d) whether during the period it complied with any externally imposed capital requirements to which it is subject.
 - (e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

The entity bases these disclosures on the information provided internally to key management personnel.

- 136 An entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities and those entities may operate in several jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity shall disclose separate information for each capital requirement to which the entity is subject.

Puttable financial instruments classified as equity

- 136A For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):**

- (a) summary quantitative data about the amount classified as equity;
- (b) its 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;
- (c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and
- (d) information about how the expected cash outflow on redemption or repurchase was determined.

Other disclosures

- 137 An entity shall disclose in the notes:**

- (a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share; and
- (b) the amount of any cumulative preference dividends not recognised.

- 138 An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:**

- (a) 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);
- (b) a description of the nature of the entity's operations and its principal activities;
- (c) the name of the parent and the ultimate parent of the group; and
- (d) if it is a limited life entity, information regarding the length of its life.

Transition and effective date

- 139 An entity shall apply this Standard for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity adopts this Standard for an earlier period, it shall disclose that fact.
- 139A HKAS 27 (as amended in 2008) amended paragraph 106. An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendment shall be applied for that earlier period. The amendment shall be applied retrospectively.
- 139B *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1), issued in June 2008, amended paragraph 138 and inserted paragraphs 8A, 80A and 136A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 32, HKAS 39, HKFRS 7 and HK(IFRIC)-Int 2 *Members' Shares in Co-operative Entities and Similar Instruments* at the same time.
- 139C Paragraphs 68 and 71 were amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 139D Paragraph 69 was amended by *Improvements to HKFRSs* issued in May 2009. An entity shall apply that amendment for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 139E ~~[Deleted]/This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 139F Paragraphs 106 and 107 were amended and paragraph 106A was added by *Improvements to HKFRSs* issued in May 2010. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted.
- 139G ~~[Deleted]/This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 139H HKFRS 10 and HKFRS 12, issued in June 2011, amended paragraphs 4, 119, 123 and 124. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 12.
- 139I HKFRS 13, issued in June 2011, amended paragraphs 128 and 133. An entity shall apply those amendments when it applies HKFRS 13.
- 139J *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraphs 7, 10, 82, 85–87, 90, 91, 94, 100 and 115, added paragraphs 10A, 81A, 81B and 82A, and deleted paragraphs 12, 81, 83 and 84. An entity shall apply those amendments for annual periods beginning on or after 1 July 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 139K HKAS 19 *Employee Benefits* (as amended in July 2011) amended the definition of 'other comprehensive income' in paragraph 7 and paragraph 96. An entity shall apply those amendments when it applies HKAS 19 (as amended in July 2011).

139L *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraphs 10, 38 and 41, deleted paragraphs 39–40 and added paragraphs 38A–38D and 40A–40D. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

139M-Ø ~~[Deleted]~~~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~

139N HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 34. An entity shall apply that amendment when it applies HKFRS 15.

139O HKFRS 9, as issued in September 2014, amended paragraphs 7, 68, 71, 82, 93, 95, 96, 106 and 123 and deleted paragraphs 139E, 139G and 139M. An entity shall apply those amendments when it applies HKFRS 9.

139P *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraphs 10, 31, 54–55, 82A, 85, 113–114, 117, 119 and 122, added paragraphs 30A, 55A and 85A–85B and deleted paragraphs 115 and 120. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. Entities are not required to disclose the information required by paragraphs 28–30 of HKAS 8 in relation to these amendments.

139Q [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

139R [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

Withdrawal of HKAS 1 (issued 2004)

140 This Standard supersedes HKAS 1 *Presentation of Financial Statements* issued in 2004, as amended in 2005.

Appendix A

Amendments to other pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2009. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.

The amendments contained in this appendix when this Standard was revised in 2007 have been incorporated into the relevant pronouncements.

Appendix B

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at December 2007 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 1.

The International Accounting Standard comparable with HKAS 1 is IAS 1 *Presentation of Financial Statements*.

The following sets out the major textual difference between HKAS 1 and IAS 1 and the reason for the difference.

Difference	Reason for the differences
(i) IAS 1 paras 15-24 vs HKAS 1 paras 15-24 The terms 'fair presentation' and 'present fairly' used in IAS 1 are replaced by the terms 'true and fair view' and 'achieve a true and fair view' in HKAS 1	To match with the terms used in the Hong Kong Companies Ordinance

Appendix C

Notes on Legal Requirements in Hong Kong

This appendix accompanies, but is not part of, HKAS 1.

The following sets out the legal requirements in Hong Kong that are pertinent to each Hong Kong Accounting Standards or Hong Kong Financial Reporting Standards. The references to “the Schedule” below are to the Tenth Schedule to the Companies Ordinance (“CO”)(Cap. 32) which continues to be effective for financial statements covering a period beginning on or before 2 March 2014.

1.	HKAS 1 <i>Presentation of Financial Statements</i>
	Sections 122 and 123 of the CO requires the directors of a company to prepare a profit and loss account for each financial year, and a balance sheet as at the last day of that year. The accounts must give a true and fair view of the profit or loss and of the state of affairs of the company, and comply with the requirements of the Schedule. Based on the communication with International Accounting Standards Board, the HKICPA believes that the term 'true and fair view' and the term 'fair presentation' used in IAS 1, <i>Presentation of Financial Statements</i> are equivalent terms. Please also refer to paragraph 46 of the Framework which contains certain references to the two terms. Sections 124 to 126 of the CO requires, where a company has a subsidiary at the end of its financial year, the directors of a company to prepare group accounts unless the company is, at the end of its financial year, a wholly owned subsidiary of another body corporate. Group accounts, which normally comprise a consolidated balance sheet and a consolidated profit and loss account, must give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries. Section 129D of the CO requires a directors' report to be attached to every balance sheet laid before a company in general meeting. The legal requirements with regard to the content of a directors' report are dealt with in Sections 129D, 129E and 141C of the CO. Section 122 of the CO requires a company's accounts, together with the directors' report and auditors' reports to be laid before the company at its annual general meeting and the accounts of private companies (other than a private company which is a member of a group of companies which includes a non-private company) and companies limited by guarantee, and all other companies to be made up to not more than 9 and 6 months, respectively, prior to the meeting. Section 111 of the CO requires that, unless approved by the Registrar of Companies, no more than 15 months should elapse between the date of one annual general meeting and the next, and that the first annual general meeting of the company must be held within 18 months of its incorporation. In general terms the legal requirements with regard to the form and content of the accounts are dealt with, inter alia, in Section 122 to 129A and Sections 161 to 161C of the CO and the Schedule.
2	HKAS 2 <i>Inventories</i>
	Paragraph 12(13) of the Schedule requires the disclosure of the manner in which the carrying amount of stock in trade or work in progress has been calculated.

3	HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
	Paragraph 17(6)* of the Schedule requires disclosure of the following: "Any material respects in which any items shown in the profit and loss account are affected – a. by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or b. by any change in the basis of accounting."
4	HKAS 10 Events After the Reporting Period
	Paragraph 9(1)(e) of the Schedule requires the disclosure of the aggregate amount which is recommended for distribution by way of dividend under a separate heading(s) in the balance sheet. Paragraph 13(1)(j) of the Schedule requires the disclosure of the aggregate amount of the dividend paid and proposed in the profit and loss account.
5	HKAS 11 Construction Contracts
	Paragraph 12(13) of the Schedule requires the disclosure of the manner in which the carrying amount of stock in trade or work in progress has been calculated.
6	HKAS 12 Incomes Taxes
	Paragraph 8* of the Schedule requires that if an amount is set aside for the purpose of its being used to prevent undue fluctuations in charges for taxation, it shall be stated. Paragraph 12(12)* the Schedule requires that, if such amount has been used during the financial year for another purpose, the amount thereof and the fact that it has been so used shall be stated. Paragraph 12(15) of the Schedule requires disclosure of the basis on which the amount, if any, set aside for Hong Kong profits tax is computed. Paragraph 13(1)(c)* of the Schedule requires disclosure of the amount of the charge to revenue for taxes imposed by the Inland Revenue Ordinance and, if that amount would have been greater but for relief from double taxation, the amount which it would have been but for such relief, and the amount of the charge for taxation imposed outside Hong Kong of profits, income and (so far as charged to revenue) capital gains. Paragraph 17(3)* of the Schedule requires that the basis on which the charge for Hong Kong profit tax is computed shall be stated. Particulars are required of any special circumstances affecting the tax liability for the financial year or succeeding financial years (paragraph 17(4) of the Schedule).

7	HKAS 16 <i>Property, Plant and Equipment</i>
	Paragraph 4[†] of the Schedule requires that fixed assets, current assets and assets that are neither fixed nor current shall be separately identified, and that the method used to arrive at the amount of fixed assets under each heading should be stated. Paragraph 5^{*†} of the Schedule requires disclosure of the aggregate amount of the cost or valuation of fixed assets under appropriate headings and of the aggregate amount provided or written off since the date of acquisition or valuation for depreciation or diminution in value. Paragraph 10 of the Schedule requires that where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured. Paragraph 12(4)[†] of the Schedule requires disclosure of particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured. Paragraph 12(6) of the Schedule requires disclosure of, where practicable, the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for and the aggregate amount or estimated amount, if it is material, of capital expenditure authorised by the directors which has not been contracted for. Paragraph 12(7)^{*†} of the Schedule requires disclosure of the years in which fixed assets were severally valued and their respective values, and in the case of assets valued during the financial period: a. the names of the persons who valued them or particulars of their qualifications for doing so; and b. the bases of valuation used by such persons. Paragraph 12(8)* of the Schedule requires disclosure of the amounts of fixed assets acquired or disposed of during the year under each heading. Where fixed assets include land, paragraph 12(9)* requires separate disclosure of the amounts ascribable to: a. land in Hong Kong held on long lease (not less than 50 years), medium-term lease (10 to 50 years) and short lease (under 10 years) respectively; and b. land outside Hong Kong held freehold, on long lease, medium-term lease and short lease respectively. Under paragraph 13(1)(a)^{*†} of the Schedule disclosure must be made of the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets.

8	HKAS 17 <i>Leases</i>
	Paragraph 13(1)(i) ^{*†} of the Schedule requires disclosure of the amount, if material, charged to revenue in respect of sums payable in respect of the hire of plant and machinery.
9	HKAS 18 <i>Revenue</i>
	Paragraph 13(1)(g)^{*†} of the Schedule requires disclosure of the amounts respectively of income from listed investments and income from unlisted investments. Paragraph 13(1)(h)[†] requires disclosure of rents from land and buildings (after deduction of ground rents, rates and other out-going) if a substantive part of the company's revenue for the financial year consists of such rents. Paragraph 16 of the Schedule requires disclosure of turnover and the method by which it is arrived at. Turnover should consist of revenue arising from the principal activities of the entity and therefore should not usually include those items of revenue and gains that arise incidentally.
10	HKAS 19 <i>Employee Benefits</i>
	The legal requirements as regards the disclosure of directors' emoluments, rights to acquire shares or debentures and other benefits are dealt with in the section below concerning HKAS 24 <i>Related Party Disclosures</i>. Under the Employment Ordinance, an enterprise is required to make long service payments to its employees upon the termination of their employment or retirement when the employee fulfils certain conditions and the termination meets the required circumstances. However, where an employee is simultaneously entitled to a long service payment and to a retirement scheme payment, the amount of the long service payment may be reduced by certain benefits arising from the retirement scheme. Based on the enterprise's past experience and the directors' knowledge of the business and work force, it is probable that the enterprise will have to make long service payments to some employees on termination of their employment or retirement. Such long service payments are accounted for as-"post-employment benefits: defined benefit plans". Paragraph 30(1) of the Schedule defines "provision" as any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or any amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. The amount provided for certain employee benefits (e.g. pensions) falls within this definition. Paragraph 4(1)[†] of the Schedule requires the classification of provisions under headings appropriate to the company's business. Paragraph 6^{*†} of the Schedule requires the disclosure of the aggregate amount of provisions (other than provisions for depreciation, renewals and diminution in value of assets) under separate headings. Paragraph 7^{*†} of the Schedule requires the disclosure of the source of any increase and the application of any decrease in each sub-heading of provisions.

	Paragraph 13(1)(f)*[†] of the Schedule requires the disclosure of the amount set aside to provisions (other than provisions for depreciation, renewals and diminution in value of assets) or the amount withdrawn from such provisions and not applied for the purposes of the provisions, if its is material. Paragraph 12(5)*[†] of the Schedule requires the disclosure of the general nature of any other contingent liabilities not provided for, and, when practicable, the aggregate amount or estimated amount of those liabilities, if it is material.
11	HKAS 20 <i>Accounting for Government Grants and Disclosure of Government Assistance</i>
	Paragraph 4[†] of the Schedule requires that the method used to arrive at the amount of fixed assets under each heading should be stated. Paragraph 5*[†] of the Schedule requires disclosure of the aggregate amount of the cost or valuation of fixed assets under appropriate headings and of the aggregate amount provided or written off since the date of acquisition or valuation for depreciation or diminution in value. Paragraph 12(5)*[†] of the Schedule requires disclosure of the general nature of any other contingent liabilities not provided for, and, when practicable, the aggregate amount or estimated amount of those liabilities, if it is material.
12	HKAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i>
	Paragraph 12(14)* of the schedule requires disclosure of the basis on which other currencies have been converted into currency in which the balance sheet is expressed, where the amount of the assets or liabilities affected is material.
13	HKAS 22 <i>Business Combinations</i>
	The legal requirements in Hong Kong with regard to the form and content of group accounts and other matters relating to subsidiaries of a company are dealt with in the section below concerning HKAS 27 <i>Consolidated and Separate Financial Statements</i>. The Schedule contains the following disclosure requirements for goodwill: a. Balance sheet Paragraph 9(1)(b) of the Schedule requires the disclosure of the unamortised balance of goodwill either as a separate item or aggregated with any unamortised balances on patents and trademarks. This requirement applies whether the goodwill is carried as a separate balance in the books or can only be ascertained from contracts or documents. b. Profit and loss account The amortisation treatment involves the allocation of cost of purchased goodwill over its useful life and can be regarded as depreciation within the meaning of the Schedule. Therefore the disclosure requirements of paragraph 13(1)(a)*[†] of that Schedule apply and the amount charged to revenue for amortisation of goodwill should be disclosed.

14	HKAS 23 <i>Borrowing Costs</i>
	Paragraph 13(1)(b)* of the Schedule requires disclosure of the following: "the amount of the interest on loans of the following kinds made to the company (whether on the security of debentures or not), namely, bank loans, overdrafts and loans which, not being bank loans or overdrafts, i. are repayable otherwise than by instalments and fall due for repayment before the expiration of the period of 5 years beginning with the day next following the expiration of the financial year; or ii. are repayable by instalments the last of which falls due for payment before the expiration of that period; and the amount of the interest on loans of other kinds so made (whether on the security of debentures or not)".
15	HKAS 24 <i>Related Party Disclosures</i>
	Section 128 of the CO requires that if at the end of its financial year, a company has subsidiaries, the following should be disclosed in the accounts: a. the subsidiary's name; b. its country of incorporation; and c. in relation to shares of each class of the subsidiary held by the company, the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held. Section 129 of the CO requires, subject to certain exemption set out in sections 129(3) to 129(5) that if at the end of its financial year, a company holds more than 20% of any class of issued shares of another body corporate (not being a subsidiary), or the shareholding in another body corporate (not being a subsidiary) exceeds 10% of the total assets of the company, the following should be disclosed: a. the name of that other body corporate; b. its country of incorporation; and c. the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held. Section 129A of the CO requires disclosure of the name and country of incorporation of the body corporate regarded by the directors as being the company's ultimate holding company. Section 129D(3)(i) of the CO requires disclosure in the directors' report of the names of the persons who, at any time during the financial year, were directors of the company. Section 129D(3)(ia) of the CO requires disclosure in the directors' report of a statement of the existence and duration of any contract in force during the year for the management and administration of the whole or any substantial part of the company's business, together with the name of any director interested therein. Section 129D(3)(j) of the CO requires disclosure in the directors' report of any interest of a director in a contract with the company or its subsidiary, holding company or fellow subsidiary, if, in the opinion of the directors, the contract is significant in relation to the company's business and the director's interest is material, whether directly or indirectly, at any time in the year, stating:

- a. the fact that the contract subsists or subsisted;
- b. the names of the parties involved (other than the company);
- c. the name of the director (if not a party);
- d. the nature of the contract; and
- e. the nature of the director's interest.

This does not apply to directors' service contracts nor to contracts between the company and another body corporate where a director's only interest is by virtue of his being a director of that other body.

Section 129D(3)(k) of the CO requires disclosure in the directors' report of any directors' rights to acquire shares or debentures, in the company or any other body corporate, under any arrangement to which the company or its subsidiary, holding company or fellow subsidiary is a party, explaining the effects of the arrangement and giving the names of all directors during the year who held shares or debentures acquired pursuant to the arrangement.

Section 161 of the CO requires disclosure of the following, distinguishing between emoluments in respect of services as director (of the company or its subsidiary) and other emoluments:

- a. the aggregate amount of directors' emoluments;
- b. the aggregate amount of directors' or past directors' pensions; and
- c. the aggregate amount of any compensation to directors or past directors in respect of loss of office, distinguishing between sums paid by or receivable from the company, its subsidiaries and any other persons.

Section 161B^Φ of the CO requires the accounts to contain certain particulars of every relevant transaction, being a loan, quasi-loan or credit transaction, entered into by the company during that financial year or, if made or entered into before it, is outstanding at any time during that financial year to the following parties:

- a. a director or an officer of the company;
- b. a director of its holding company;
- c. a body corporate controlled by a director of the company; or
- d. persons etc. connected with a director of the company or of its holding company;

Paragraph 9(1)(c) of the Schedule requires disclosure of loans to employees, or to trustees for employees (including salaried directors), to purchase fully paid shares in the company or in its holding company.

Paragraph 18(2)* of the CO of the Schedule requires the aggregate amounts of shares in, and the amounts owing from (and indebtedness to) the company's subsidiaries to be set out separately from all other assets (and liabilities) of the company.

	Paragraph 18(3)* of the CO requires disclosure of the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees except where the subsidiaries or their nominees hold the shares as trustees and neither the company nor the subsidiaries have any beneficial interest in those shares. Paragraph 19(1)* of the CO of the Schedule requires disclosure of the aggregate amounts owing from and indebtedness to the company's holding companies and fellow subsidiaries, and the aggregate amount of assets consisting of shares in fellow subsidiaries.
16	HKAS 27 <i>Consolidated and Separate Financial Statements</i>
	Under section 2(4) of the CO, a company shall be deemed to be a subsidiary of another company, if: a. that other company: i. controls the composition of the board of directors of the first mentioned company; or ii. controls more than half of the voting power of the first mentioned company; or iii. holds more than half of the issued share capital of the first mentioned company (excluding any part of it which carries no right to participate beyond a specified amount in a distribution of either profits or capital); or b. the first mentioned company is a subsidiary of any company which is that other company's subsidiary. For the purposes of defining a subsidiary under section 2(4) of the CO, section 2(5) of the CO states that the composition of a company's board of directors shall be deemed to be controlled by another company if that other company by the exercise of some power exercisable by it, without the consent of any other person, can appoint or remove all or a majority of the directors, and, for the purposes of this provision, that other company shall be deemed to have power to make such an appointment if: a. a person cannot be appointed as a director without the exercise in his favour by that other company of such a power; or b. a person's appointment as a director follows necessarily from his being a director or other officer of that other company.

	The Companies (Amendment) Ordinance 2005 introduced a definition of "parent undertaking" and "subsidiary undertaking". A provision to deem a holding company to include a parent company and a subsidiary to include a subsidiary undertaking was added in Section 2B. In essence, this enable Hong Kong incorporated companies to use the definition of subsidiary in HKAS 27 for the purpose of preparing group accounts. Parent undertaking and subsidiary undertaking are defined in Schedule 23 as follows: (1) An undertaking is a parent undertaking ("parent undertaking") in relation to another undertaking ("subsidiary undertaking") if— (a) (i) in the case where both the parent undertaking and the subsidiary undertaking are bodies corporate, the subsidiary undertaking is a subsidiary of the parent undertaking by virtue of section 2(4), (5), (6) and (7) of the CO; or (ii) in any other case, the parent undertaking— (A) holds a majority of the voting rights in the subsidiary undertaking; (B) is a member of the subsidiary undertaking and has the right to appoint or remove a majority of its board of directors; or (C) is a member of the subsidiary undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the subsidiary undertaking; or (b) the parent undertaking has the right to exercise a dominant influence over the subsidiary undertaking by virtue of— (i) the provisions contained in the subsidiary undertaking's memorandum or articles or equivalent constitutional documents; or (ii) a control contract. (2) For the purposes of subsection (1)(a)(ii), an undertaking shall be treated as a member of another undertaking ("the relevant undertaking"), if— (a) any of its subsidiary undertakings is a member of the relevant undertaking; or (b) any shares in the relevant undertaking are held by a person acting on behalf of the first-mentioned undertaking or any of its subsidiary undertakings. (3) An undertaking shall be treated as the parent undertaking of another undertaking if a subsidiary undertaking of the first-mentioned undertaking is, or is to be treated as, the parent undertaking of that other undertaking; and references to a subsidiary undertaking of the first-mentioned undertaking shall be construed accordingly. The obligation to lay group accounts before the members of a holding company in general meeting is set out in section 124(1) of the CO. In general terms the form and content of group accounts are dealt with inter alia in sections 125 and 126 of the CO and in the Schedule.

	Under section 124(2)(a) of the CO group accounts shall not be required where the holding company is at the end of its financial year the wholly-owned subsidiary of another body corporate. Section 124(2)(b) of the Companies Ordinance also allows group accounts (subject to approval of the Financial Secretary in certain instances) not to deal with a subsidiary if the company's directors are of the opinion that: - it is impracticable, or would be of no real value to members of the company, in view of the insignificant amount involved, or would involve expense or delay out of proportion to the value to members of the company; or - the result would be misleading, or harmful to the business of the company or any of its subsidiaries; or - the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking. It should be noted that HKAS 27 takes the view that all subsidiaries should be included in the consolidated financial statements. In general, section 125 of the CO requires group accounts to be presented in the form of consolidated accounts and should comprise a consolidated balance sheet and a consolidated profit and loss account dealing with the state of affairs and profit or loss of the company and its subsidiaries. However, section 125 of the CO also accepts that group accounts may be presented in a form other than a single set of consolidated accounts under certain conditions. It is generally accepted that consolidated financial statements are usually the best means of achieving the objective of giving a true and fair view of the profit or loss and of the state of affairs of the group. It should be noted that, where subsidiaries are not dealt with in group accounts or are being dealt with in a form of group accounts other than consolidated financial statements, information may still be required by law about the results of these subsidiaries and the extent to which they have been dealt with in the accounts of the holding company (paragraphs 18(4) and 24 of the Schedule). Section 127(1) of the CO states that a holding company's directors shall secure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year. Section 126(2) of the CO requires that, if the financial year of a subsidiary is not co-terminous with that of the holding company, the group accounts shall deal with the subsidiary's results and state of affairs as of the last financial year ending on or before the date of the holding company's balance sheet. It also requires the disclosure of the reasons why the financial year of a subsidiary does not coincide with that of the holding company. Paragraph 18(2) and 19(1) of the Schedule require disclosure of the aggregate amounts of shares in, and the amounts owing from and indebtedness to, the subsidiaries and fellow subsidiaries.

	Paragraphs 18(4), 18(5) and 24(b) of the Schedule require disclosure of the following information where group accounts are not submitted: - the reasons why subsidiaries are not dealt with in group accounts; - the net aggregate amount attributable to the holding company of the profits less losses of such subsidiaries, dealt with this year and not dealt with, in the company's accounts, both for: - the financial years of subsidiaries ending with or during the financial year of the company; and - their previous financial years since acquisition; and - any material qualifications in the auditors' report and any note to the accounts disclosing a matter which, in the absence of such disclosure, would have been referred to in an audit report qualification, to the extent that the matter is not referred to in the holding company's audit report and is material from the point of view of its members. Paragraphs 18(6) and 25 of the Schedule requires disclosure of the following information where group accounts are not submitted and the subsidiaries' financial year did not end with that of the company: - the reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and - the dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates. The Companies (Amendment) Ordinance 2005, in general, redefines the definition of "subsidiary" for the purpose of preparing group accounts to include a subsidiary undertaking as defined in the new Schedule 23 and includes a true and fair overriding provision. In essence, this would enable Hong Kong incorporated companies to use the definition of subsidiary in HKAS 27 for the purpose of preparing group accounts.
17	HKAS 28 <i>Investment in Associates</i>
	Section 129 of the Companies Ordinance requires that if at the balance sheet date, a company holds more than 20% of any class of issued shares of another company, or the shareholding in another company exceeds 10% of the total assets of the investing company, the following should be disclosed subject to sections 129(3) to 129(5) of the CO: - the name of that other company; - its country of incorporation; and - the identity of the class and the proportion of the nominal value of the issued share of that class represented by the shares held. In the case of an investee company which is either incorporated outside Hong Kong or carries on business outside Hong Kong, section 129(3) of the Companies Ordinance provides that disclosure of the company's name and other particulars need not be made if in the opinion of the directors and with the concurrence of the Financial Secretary such disclosure would be harmful.

	Paragraph 9(1)(a)[†] of the Schedule requires separate disclosure of the aggregate amounts respectively of listed investments and unlisted investments. Paragraph 9(3)[†] of the Schedule requires that the amount of listed investments in the balance sheet should be analysed into those listed in Hong Kong and those listed outside Hong Kong. Paragraph 12(5)[†] of the Schedule requires disclosure of the general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material. Paragraph 12(6) of the Schedule requires disclosure of, where practicable, the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for and the aggregate amount or estimated amount, if it is material, of capital expenditure authorised by the directors which has not been contracted for. Paragraph 13(1)(g)^{*†} of the Schedule requires disclosure of the amounts respectively of income from listed investments and income from unlisted investments.
18	HKAS 31 <i>Interests in Joint Ventures</i>
	Section 129 of the Companies Ordinance requires that if at the balance sheet date, a company holds more than 20% of any class of issued shares of another company, or the shareholding in another company exceeds 10% of the total assets of the investing company, the following should be disclosed: - the name of that other company; - its country of incorporation; and - the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held. In the case of an investee company which is either incorporated outside Hong Kong or carries on business outside Hong Kong, section 129(3) of the Companies Ordinance provides that disclosure of a company's name and other particulars need not be made if in the opinion of the directors and with the concurrence of the Financial Secretary such disclosure would be harmful. Paragraph 9(1)(a)[†] of the Schedule requires separate disclosure of the aggregate amounts respectively of listed investments and unlisted investments. Paragraph 9(3)[†] of the Schedule requires that the amount of listed investments in the balance sheet should be analysed into those listed in Hong Kong and those listed outside Hong Kong. Paragraph 12(5)[†] of the Schedule requires disclosure of the general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material. Paragraph 12(6) of the Schedule requires disclosure of, where practicable, the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for and the aggregate amount or estimated amount, if it is material, of capital expenditure authorised by the directors which has not been contracted for. Paragraph 13(1)(g)^{*†} of the Schedule requires disclosure of the amounts respectively of income from listed investments and income from unlisted investments.

19	HKAS 36 <i>Impairment of Assets</i>
	Paragraph 30(1) of the Schedule defines "provision" as any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. This covers the definition of "impairment loss" in paragraph 5 of HKAS 36. Paragraph 4(1)[†] of the Schedule requires the classification of provisions under headings appropriate to the company's business. Paragraph 7*[†] of the Schedule requires the disclosure of the source of any increase and the application of any decrease in each sub-heading of provisions.
20	HKAS 37 <i>Provisions, Contingent Liabilities And Contingent Assets</i>
	Paragraph 30(1) of the Schedule defines "provision" as any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or any amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. This definition is wider in scope than the definition in HKAS 37. Paragraph 4(1)[†] of the Schedule requires the classification of provisions under headings appropriate to the company's business. Paragraph 6*[†] of the Schedule requires the disclosure of the aggregate amount of provisions (other than provisions for depreciation, renewals and diminution in value of assets) under separate headings. Paragraph 7*[†] of the Schedule requires the disclosure of the source of any increase and the application of any decrease in each sub-heading of provisions. Paragraph 13(1)(f)*[†] of the Schedule requires the disclosure of the amount set aside to provisions (other than provisions for depreciation, renewals and diminution in value of assets) or the amount withdrawn from such provisions and not applied for the purposes of the provisions, if it is material. Paragraph 12(4)[†] of the Schedule requires the disclosure of particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured. Paragraph 12(5)[†] of the Schedule requires the disclosure of the general nature of any other contingent liabilities not provided for, and, when practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

21	HKAS 38 <i>Intangible Assets</i>
	Paragraph 9(1)(b) of the Schedule requires the disclosure of the unamortised balances on patents and trademarks either as separate items or aggregated with any unamortised balance of goodwill. This requirement applies whether the patents and trademarks are carried as balances in the books or can only be ascertained from contracts or documents. The amortisation treatment involves the allocation of the depreciable amount of an intangible asset over the best estimate of its useful life and can be regarded as depreciation within the meaning of the Schedule. Therefore, the disclosure requirements of paragraph 13(1)(a)*[†] of the Schedule apply and the amount charged to revenue for amortisation of an intangible asset should be disclosed.
22	HKAS 40 <i>Investment Property</i>
	Paragraph 5*[†] of the Schedule requires disclosure of the aggregate amount of the cost or valuation of fixed assets under appropriate headings and of the aggregate amount provided or written off since the date of acquisition or valuation for depreciation or diminution in value. Paragraph 10 of the Schedule requires that where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured. Paragraph 12(4)[†] of the Schedule requires disclosure of particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured. Paragraph 12(7)*[†] of the Schedule requires disclosure of the years in which fixed assets were severally valued and their respective values, and in the case of assets valued during the financial period: a. the name of the persons who valued them or particulars of their qualifications for doing so; and b. the bases of valuation used by such persons. Paragraph 12(8)*[†] of the Schedule requires disclosure of the aggregate amounts of fixed assets acquired or disposed of during the year under each heading. Where fixed assets include land, paragraph 12(9)* requires separate disclosure of the amounts ascribable to: a. land in Hong Kong held on long lease, medium-term lease and short lease respectively; and b. land outside Hong Kong held freehold, on long lease, medium-term lease and short lease respectively. Under paragraph 13(1)(a)*[†] of the Schedule disclosure must be made of the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets. Paragraph 13(1)(h)[†] of the Schedule requires disclosure of rental income from land and buildings (after deduction of ground rents, rates and other out-goings) if a substantive part of the company's revenue for the financial year consists of such rents.

23	HKAS 41 <i>Agriculture</i>
	Paragraph 12(5)[†] of the Schedule requires disclosure of the general nature of any other contingent liabilities not provided for, and, when practicable, the aggregate amount or estimated amount of those liabilities, if it is material. Paragraph 12(7)^{*†} of the Schedule requires disclosure of the years in which fixed assets were severally valued and their respective values, and in the case of assets valued during the financial period: - the names of the persons who valued them or particulars of their qualifications for doing so; and - the bases of valuation used by such persons. Under paragraph 13(1)(a)^{*†} of the Schedule disclosure must be made of the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets.
24	HKFRS 7 <i>Financial Instruments: Disclosures</i>
	Section 129 of the Companies Ordinance requires that if at the balance sheet date, a company holds more than 20% of any class of issued shares of another company, or the shareholding in another company exceeds 10% of the total assets of the investing company, the following should be disclosed: - the name of that other company; - its country of incorporation; and - the identity of the class and the proportion of the nominal value of the issued shares of that class represented by the shares held. Paragraph 4(2)[†] of the Schedule requires fixed assets, current assets and assets that are neither fixed nor current to be separately identified. Paragraph 5^{*†} of the Schedule requires that where the directors' valuation of unlisted investments is not given and such investments are classified as fixed assets, the following should be stated: - cost or valuation as shown in the company's books; and - any amount provided or written off for diminution in value. Paragraph 9(1)(a) of the Schedule requires separate disclosure of the aggregate amounts respectively of listed investments and unlisted investments. Paragraph 9(1)(d) requires disclosure of the aggregate amount of banks loans and overdrafts and the aggregate amount of loans (other than bank loans and overdrafts) repayable wholly in part more than five years from the balance sheet date. Paragraph 9(3)[†] of the Schedule requires that the carrying amounts of listed investments in the balance sheet should be analysed into those listed in Hong Kong and those listed outside Hong Kong. Paragraph 9(4) of the Schedule requires disclosure of the terms of repayments and the rate of interests for each loan, other than a bank loan or an overdraft, specified in paragraph 9(1)(d) of the Schedule

	Paragraph 12(10) of the Schedule requires that, if in the opinion of the directors, the realisable value of any current assets is less than the balance sheet value, a statement of that fact should be included in the accounts. Paragraph 12(11)^{*†} of the Schedule requires disclosure of the aggregate market value of listed investments where it differs from the carrying amounts in the balance sheet. If the aggregate market value is higher than the Stock Exchange value, the Stock Exchange value should also be disclosed. Paragraph 13(1)(a)^{*†} of the Schedule requires disclosure of the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets. Paragraph 13(1)(g)^{*†} of the Schedule requires disclosure of the amounts respectively of income from listed investments and income from unlisted investments.

Notes: * These requirements do not apply to banking companies that are entitled to certain disclosure exemptions under Part III of the Schedule.

† These requirements do not apply to insurance companies that are entitled to certain disclosure exemptions under Part III of the Schedule.

Φ This revised S161B of the CO came into operation for relevant transactions entered into by the company after 13 February 2004.

BASIS FOR CONCLUSIONS ON IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

This Basis for Conclusions accompanies, but is not part of, IAS 1.

HKAS 1 is based on IAS 1 *Presentation of Financial statements*. In approving HKAS 1, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 1. Accordingly, there are no significant differences between HKAS 1 and IAS 1. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 1 referred to below generally correspond with those in HKAS 1.

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DISSENTING OPINIONS

GUIDANCE ON IMPLEMENTING

IAS 1 *PRESENTATION OF FINANCIAL STATEMENTS*

Basis for Conclusions on IAS 1 *Presentation of Financial Statements*

This Basis for Conclusions accompanies, but is not part of, IAS 1.

The International Accounting Standards Board revised IAS 1 Presentation of Financial Statements in 2007 as part of its project on financial statement presentation. It was not the Board's intention to reconsider as part of that project all the requirements in IAS 1.

For convenience, the Board has incorporated into this Basis for Conclusions relevant material from the Basis for Conclusions on the revision of IAS 1 in 2003 and its amendment in 2005. Paragraphs have been renumbered and reorganised as necessary to reflect the new structure of the Standard.

~~References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.~~

Introduction

BC1 The International Accounting Standards Committee (IASC) issued the first version of IAS 1 *Disclosure of Accounting Policies* in 1975. It was reformatted in 1994 and superseded in 1997 by IAS 1 *Presentation of Financial Statements*.^{*} In 2003 the International Accounting Standards Board revised IAS 1 as part of the Improvements project and in 2005 the Board amended it as a consequence of issuing IFRS 7 *Financial Instruments: Disclosures*. In 2007 the Board revised IAS 1 again as part of its project on financial statement presentation. This Basis for Conclusions summarises the Board's considerations in reaching its conclusions on revising IAS 1 in 2003, on amending it in 2005 and revising it in 2007. It includes reasons for accepting some approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

The Improvements project—revision of IAS 1 (2003)

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of standards, including IAS 1. The project was undertaken in the light of queries and criticisms raised in relation to the standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within standards, to deal with some convergence issues and to make other improvements. The Board's intention was not to reconsider the fundamental approach to the presentation of financial statements established by IAS 1 in 1997.

BC3 In May 2002 the Board published an exposure draft of proposed *Improvements to International Accounting Standards*, which contained proposals to revise IAS 1. The Board received more than 160 comment letters. After considering the responses the Board issued in 2003 a revised version of IAS 1. In its revision the Board's main objectives were:

- (a) to provide a framework within which an entity assesses how to present fairly the effects of transactions and other events, and assesses whether the result of complying with a requirement in an IFRS would be so misleading that it would not give a fair presentation;
- (b) to base the criteria for classifying liabilities as current or non-current solely on the conditions existing at the balance sheet date;
- (c) to prohibit the presentation of items of income and expense as 'extraordinary items';

^{*} IASC did not publish a Basis for Conclusions.

- (d) to specify disclosures about the judgements that management has made in the process of applying the entity's accounting policies, apart from those involving estimations, and that have the most significant effect on the amounts recognised in the financial statements; and
 - (e) to specify disclosures about sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- BC4 The following sections summarise the Board's considerations in reaching its conclusions as part of its Improvements project in 2003:
- (a) departures from IFRSs (paragraphs BC23–BC30)
 - (b) criterion for exemption from requirements (paragraphs BC34–BC36)
 - (c) effect of events after the reporting period on the classification of liabilities (paragraphs BC39–BC48)
 - (d) results of operating activities (paragraphs BC55 and BC56)
 - (e) minority interest (paragraph BC59)*
 - (f) extraordinary items (paragraphs BC60–BC64)
 - (g) disclosure of the judgements management has made in the process of applying the entity's accounting policies (paragraphs BC77 and BC78)
 - (h) disclosure of major sources of estimation uncertainty (paragraphs BC79–BC84).

Amendment to IAS 1—*Capital Disclosures* (2005)

- BC5 In August 2005 the Board issued an Amendment to IAS 1—*Capital Disclosures*. The amendment added to IAS 1 requirements for disclosure of:
- (a) the entity's objectives, policies and processes for managing capital.
 - (b) quantitative data about what the entity regards as capital.
 - (c) whether the entity has complied with any capital requirements; and if it has not complied, the consequences of such non-compliance.
- BC6 The following sections summarise the Board's considerations in reaching its conclusions as part of its amendment to IAS 1 in 2005:
- (a) disclosures about capital (paragraphs BC85–BC89)
 - (b) objectives, policies and processes for managing capital (paragraphs BC90 and BC91)
 - (c) externally imposed capital requirements (paragraphs BC92–BC97)
 - (d) internal capital targets (paragraphs BC98–BC100).

* In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended 'minority interest' to 'non-controlling interests'. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The term 'non-controlling interests' and the requirements for non-controlling interests were not changed.

Amendments to IAS 32 and IAS 1—*Puttable Financial Instruments and Obligations Arising on Liquidation* (2008)

- BC6A In July 2006 the Board published an exposure draft of proposed amendments to IAS 32 and IAS 1 relating to the classification of puttable instruments and instruments with obligations arising only on liquidation. The Board subsequently confirmed the proposals and in February 2008 issued an amendment that now forms part of IAS 1.

***Presentation of Items of Other Comprehensive Income* (Amendments to IAS 1)**

- BC6B In May 2010 the Board published an exposure draft of proposed amendments to IAS 1 relating to the presentation of items of other comprehensive income (OCI). The Board subsequently modified and confirmed the proposals and in June 2011 issued *Presentation of Items of Other Comprehensive Income* (Amendments to IAS 1). The amendments were developed in a joint project with the US national standard-setter, the Financial Accounting Standards Board (FASB), with the aim of aligning the presentation of OCI so that information in financial statements prepared by entities using IFRSs and entities using US generally accepted accounting principles (GAAP) can be more easily compared.

Financial statement presentation—Joint project

- BC7 In September 2001 the Board added to its agenda the performance reporting project (in March 2006 renamed the 'financial statement presentation project'). The objective of the project was to enhance the usefulness of information presented in the income statement. The Board developed a possible new model for reporting income and expenses and conducted preliminary testing. Similarly, in the United States, the Financial Accounting Standards Board (FASB) added a project on performance reporting to its agenda in October 2001, developed its model and conducted preliminary testing. Constituents raised concerns about both models and about the fact that they were different.
- BC8 In April 2004 the Board and the FASB decided to work on financial statement presentation as a joint project. They agreed that the project should address presentation and display not only in the income statement, but also in the other statements that, together with the income statement, would constitute a complete set of financial statements—the balance sheet, the statement of changes in equity, and the cash flow statement. The Board decided to approach the project in two phases. Phase A would address the statements that constitute a complete set of financial statements and the periods for which they are required to be presented. Phase B would be undertaken jointly with the FASB and would address more fundamental issues relating to presentation and display of information in the financial statements, including:
- (a) consistent principles for aggregating information in each financial statement.
 - (b) the totals and subtotals that should be reported in each financial statement.
 - (c) whether components of other comprehensive income should be reclassified to profit or loss and, if so, the characteristics of the transactions and events that should be reclassified and when reclassification should be made.
 - (d) whether the direct or the indirect method of presenting operating cash flows provides more useful information.

- BC9 In March 2006, as a result of its work in phase A, the Board published an exposure draft of proposed amendments to IAS 1—*A Revised Presentation*. The Board received more than 130 comment letters. The exposure draft proposed amendments that affected the presentation of owner changes in equity and the presentation of comprehensive income, but did not propose to change the recognition, measurement or disclosure of specific transactions and other events required by other IFRSs. It also proposed to bring IAS 1 largely into line with the US standard—SFAS 130 *Reporting Comprehensive Income*. After considering the responses to the exposure draft the Board issued a revised version of IAS 1. The FASB decided to consider phases A and B issues together, and therefore did not publish an exposure draft on phase A.
- BC10 The following sections summarise the Board's considerations in reaching its conclusions as part of its revision in 2007:
- (a) general purpose financial statements (paragraphs BC11–BC13)
 - (b) titles of financial statements (paragraphs BC14–BC21)
 - (c) equal prominence (paragraph BC22)
 - (d) a statement of financial position as at the beginning of the earliest comparative period (paragraphs BC31 and BC32)
 - (e) IAS 34 *Interim Financial Reporting* (paragraph BC33)
 - (f) reporting owner and non-owner changes in equity (paragraphs BC37 and BC38)
 - (g) reporting comprehensive income (paragraphs BC49–BC54)
 - (h) subtotal for profit or loss (paragraphs BC57 and BC58)
 - (i) other comprehensive income-related tax effects (paragraphs BC65– BC68)
 - (j) reclassification adjustments (paragraphs BC69–BC73)
 - (k) effects of retrospective application or retrospective restatement (paragraph BC74)
 - (l) presentation of dividends (paragraph BC75)
 - (m) IAS 7 *Cash Flow Statements* (paragraph BC76)
 - (n) presentation of measures per share (paragraphs BC101–BC104)
 - (o) effective date and transition (paragraph BC105)
 - (p) differences from SFAS 130 (paragraph BC106).

Definitions

General purpose financial statements (paragraph 7)

- BC11 The exposure draft of 2006 proposed a change to the explanatory paragraph of what 'general purpose financial statements' include, in order to produce a more generic definition of a set of financial statements. Paragraph 7 of the exposure draft stated:

General purpose financial statements include those that are presented separately or within other *public* documents such as a *regulatory filing* or report to shareholders. [emphasis added]

- BC12 Respondents expressed concern about the proposed change. They argued that it could be understood as defining as general purpose financial statements any financial statement or set of financial statements filed with a regulator and could capture documents other than annual reports and prospectuses. They saw this change as expanding the scope of IAS 1 to documents that previously would not have contained all of the disclosures required by IAS 1. Respondents pointed out that the change would particularly affect some entities (such as small private companies and subsidiaries of public companies with no external users of financial reports) that are required by law to place their financial statements on a public file.
- BC13 The Board acknowledged that in some countries the law requires entities, whether public or private, to report to regulatory authorities and include information in those reports that could be beyond the scope of IAS 1. Because the Board did not intend to extend the definition of general purpose financial statements, it decided to eliminate the explanatory paragraph of what 'general purpose financial statements' include, while retaining the definition of 'general purpose financial statements'.

Financial statements

Complete set of financial statements

Titles of financial statements (paragraph 10)

- BC14 The exposure draft of 2006 proposed changes to the titles of some of the financial statements—from 'balance sheet' to 'statement of financial position', from 'income statement' to 'statement of profit or loss' and from 'cash flow statement' to 'statement of cash flows'. In addition, the exposure draft proposed a 'statement of recognised income and expense' and that all owner changes in equity should be included in a 'statement of changes in equity'. The Board did not propose to make any of these changes of nomenclature mandatory.
- BC15 Many respondents opposed the proposed changes, pointing out that the existing titles had a long tradition and were well understood. However, the Board reaffirmed its view that the proposed new titles better reflect the function of each financial statement, and pointed out that an entity could choose to use other titles in its financial report.
- BC16 The Board reaffirmed its conclusion that the title 'statement of financial position' not only better reflects the function of the statement but is consistent with the *Framework for the Preparation and Presentation of Financial Statements*, which contains several references to 'financial position'. Paragraph 12 of the *Framework** states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity; paragraph 19 of the *Framework* states that information about financial position is primarily provided in a balance sheet. In the Board's view, the title 'balance sheet' simply reflects that double entry bookkeeping requires debits to equal credits. It does not identify the content or purpose of the statement. The Board also noted that 'financial position' is a well-known and accepted term, as it has been used in auditors' opinions internationally for more than 20 years to describe what the 'balance sheet' presents. The Board decided that aligning the statement's title with its content and the opinion rendered by the auditor would help the users of financial statements.

* References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statement* adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- BC17 As to the other statements, respondents suggested that renaming the balance sheet the 'statement of financial position' implied that the 'cash flow statement' and the 'statement of recognised income and expense' do not also reflect an entity's financial position. The Board observed that although the latter statements reflect changes in an entity's financial position, neither can be called a 'statement of changes in financial position', as this would not depict their true function and objective (ie to present cash flows and performance, respectively). The Board acknowledged that the titles 'income statement' and 'statement of profit or loss' are similar in meaning and could be used interchangeably, and decided to retain the title 'income statement' as this is more commonly used.
- BC18 The title of the proposed new statement, the 'statement of recognised income and expense', reflects a broader content than the former 'income statement'. The statement encompasses both income and expenses recognised in profit or loss and income and expenses recognised outside profit or loss.
- BC19 Many respondents opposed the title 'statement of recognised income and expense', objecting particularly to the use of the term 'recognised'. The Board acknowledged that the term 'recognised' could also be used to describe the content of other primary statements as 'recognition', explained in paragraph 82 of the *Framework*, is 'the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83.' Many respondents suggested the term 'statement of comprehensive income' instead.
- BC20 In response to respondents' concerns and to converge with SFAS 130, the Board decided to rename the new statement a 'statement of comprehensive income'. The term 'comprehensive income' is not defined in the *Framework* but is used in IAS 1 to describe the change in equity of an entity during a period from transactions, events and circumstances other than those resulting from transactions with owners in their capacity as owners. Although the term 'comprehensive income' is used to describe the aggregate of all components of comprehensive income, including profit or loss, the term 'other comprehensive income' refers to income and expenses that under IFRSs are included in comprehensive income but excluded from profit or loss.
- BC20A In May 2010 the Board published the exposure draft *Presentation of Items of Other Comprehensive Income* (proposed amendments to IAS 1) relating to the presentation of items of other comprehensive income (OCI). One of the proposals in the exposure draft related to the title of the statement containing profit or loss and other comprehensive income. The Board proposed this change so that it would be clear that the statement had two components: profit or loss and other comprehensive income. A majority of the respondents to the exposure draft supported the change and therefore the Board confirmed the proposal in June 2011. IAS 1 allows preparers to use other titles for the statement that reflect the nature of their activities.
- BC20B Several other IFRSs refer to the 'statement of comprehensive income'. The Board considered whether it should change all such references to 'statement of profit or loss and other comprehensive income'. The Board noted that the terminology used in IAS 1 is not mandatory and that 'statement of comprehensive income' is one of the examples used in the standard. The Board decided that there was little benefit in replacing the title 'statement of comprehensive income' in other IFRSs or 'income statement' with the 'statement of profit or loss'. However, the Board did change the terminology when an IFRS made reference to the two-statement option.
- BC21 In finalising its revision, the Board confirmed that the titles of financial statements used in this Standard would not be mandatory. The titles will be used in future IFRSs but are not required to be used by entities in their financial statements. Some respondents to the exposure draft expressed concern that non-mandatory titles will result in confusion. However, the Board believes that making use of the titles non-mandatory will allow time for entities to implement changes gradually as the new titles become more familiar.

Equal prominence (paragraphs 11 and 12)

- BC22 The Board noted that the financial performance of an entity is not assessed by reference to a single financial statement or a single measure within a financial statement. The Board believes that the financial performance of an entity can be assessed only after all aspects of the financial statements are taken into account and understood in their entirety. Accordingly, the Board decided that in order to help users of the financial statements to understand the financial performance of an entity comprehensively, all financial statements within the complete set of financial statements should be presented with equal prominence.

Departures from IFRSs (paragraphs 19–24)

- BC23 IAS 1 (as issued in 1997) permitted an entity to depart from a requirement in a Standard 'in the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading, and therefore that departure from a requirement is necessary to achieve a fair presentation' (paragraph 17, now paragraph 19). When such a departure occurred, paragraph 18 (now paragraph 20) required extensive disclosure of the facts and circumstances surrounding the departure and the treatment adopted.
- BC24 The Board decided to clarify in paragraph 15 of the Standard that for financial statements to present fairly the financial position, financial performance and cash flows of an entity, they must represent faithfully the effects of transactions and other events in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.
- BC25 The Board decided to limit the occasions on which an entity should depart from a requirement in an IFRS to the extremely rare circumstances in which management concludes that compliance with the requirement would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*. Guidance on this criterion states that an item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events or conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements.
- BC26 These amendments provide a framework within which an entity assesses how to present fairly the effects of transactions, other events and conditions, and whether the result of complying with a requirement in an IFRS would be so misleading that it would not give a fair presentation.
- BC27 The Board considered whether IAS 1 should be silent on departures from IFRSs. The Board decided against making that change, because it would remove the Board's capability to specify the criteria under which departures from IFRSs should occur.
- BC28 Departing from a requirement in an IFRS when considered necessary to achieve a fair presentation would conflict with the regulatory framework in some jurisdictions. The revised IAS 1 takes into account the existence of different regulatory requirements. It requires that when an entity's circumstances satisfy the criterion described in paragraph BC25 for departure from a requirement in an IFRS, the entity should proceed as follows:
- (a) When the relevant regulatory framework requires—or otherwise does not prohibit—a departure from the requirement, the entity should make that departure and the disclosures set out in paragraph 20.
 - (b) When the relevant regulatory framework prohibits departure from the requirement, the entity should, to the maximum extent possible, reduce the perceived misleading aspects of compliance by making the disclosures set out in paragraph 23.

This amendment enables entities to comply with the requirements of IAS 1 when the relevant regulatory framework prohibits departures from accounting standards, while retaining the principle that entities should, to the maximum extent possible, ensure that financial statements provide a fair presentation.

- BC29 After considering the comments received on the exposure draft of 2002, the Board added to IAS 1 a requirement in paragraph 21 to disclose the effect of a departure from a requirement of an IFRS in a prior period on the current period's financial statements. Without this disclosure, users of the entity's financial statements could be unaware of the continuing effects of prior period departures.
- BC30 In view of the strict criteria for departure from a requirement in an IFRS, IAS 1 includes a rebuttable presumption that if other entities in similar circumstances comply with the requirement, the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the *Framework*.

Materiality and aggregation (paragraphs 29–31)

- BC30A The Board was informed at the Discussion Forum *Financial Reporting Disclosure* in January 2013, in its related survey and by other sources, that there are difficulties applying the concept of materiality in practice. Some are of the view that these difficulties contribute to a disclosure problem, namely, that there is both too much irrelevant information and not enough relevant information in financial statements. A number of factors have been identified for why materiality may not be applied well in practice. One of these is that the guidance on materiality in IFRS is not clear.
- BC30B Some think that the statement in IAS 1 that an entity need not provide a specific disclosure if the information is not material means that an entity does not need to present an item in the statement(s) of profit or loss and other comprehensive income, the statement of financial position, the statement of cash flows and the statement of changes in equity, but must instead disclose it in the notes. However, the Board noted that the concept of materiality is applicable to financial statements, which include the notes, and not only to those statements.
- BC30C Some are of the view that when IFRS states that a specific disclosure is required, the concept of materiality does not apply to those disclosure requirements, ie disclosures specifically identified in IFRS are required irrespective of whether they result in material information. In addition, some people think that when a line item is presented, or a material item is otherwise recognised, in the statement(s) of profit or loss and other comprehensive income and the statement of financial position, all the disclosures in IFRS specified for that item must be disclosed. The Board observed that paragraph 31 of IAS 1 is clear that the concept of materiality applies to specific disclosures required by an IFRS and therefore an entity does not have to disclose information required by an IFRS if that information would not be material.
- BC30D The Board understands that these misconceptions may have arisen because of the wording that is used when specifying presentation or disclosure requirements in IFRS; for example, the use of the words 'as a minimum'. For this reason, the Board removed the phrase 'as a minimum' in paragraph 54 of IAS 1, which lists line items for presentation in the statement of financial position. This also makes the requirement broadly consistent with the corresponding requirement in paragraph 82 of IAS 1 for the profit or loss section of the statement of comprehensive income or the statement of profit or loss.
- BC30E On the basis of its observations and conclusions set out in paragraphs BC30A–BC30D, the Board added a new paragraph, paragraph 30A, and amended paragraph 31 of IAS 1.

- BC30F Paragraph 30A was added to IAS 1 to highlight that when an entity decides how it aggregates information in the financial statements, it should take into consideration all relevant facts and circumstances. Paragraph 30A emphasises that an entity should not reduce the understandability of its financial statements by providing immaterial information that obscures the material information in financial statements or by aggregating material items that have different natures or functions. Obscuring material information with immaterial information in financial statements makes the material information less visible and therefore makes the financial statements less understandable. The amendments do not actually prohibit entities from disclosing immaterial information, because the Board thinks that such a requirement would not be operational; however, the amendments emphasise that disclosure should not result in material information being obscured.
- BC30G The Exposure Draft *Disclosure Initiative* (Proposed amendments to IAS 1) (the 'March 2014 Exposure Draft'), which was published in March 2014, also proposed that an entity should not 'disaggregate' information in a manner that obscures useful information. Disaggregation is often used to describe the process of expanding totals, subtotals and line items into further items that themselves may reflect the aggregated results of transactions or other events. Because the process of expanding totals, subtotals and line items is more likely to increase the transparency of information rather than obscuring it, the Board decided not to include the term disaggregation in paragraph 30A of IAS 1. In addition, the Board was of the view that items resulting from the process of disaggregation that themselves reflect the aggregated results of transactions would be covered by paragraphs 29–31 of IAS 1.
- BC30H The Board amended paragraph 31 of IAS 1 to highlight that materiality also applies to disclosures specifically required by IFRS. In addition, to highlight that materiality not only involves decisions about excluding information from the financial statements, the Board amended paragraph 31 to reiterate the notion already stated in paragraph 17(c) of IAS 1 that materiality also involves decisions about whether to include additional information in the financial statements. Consequently, an entity should make additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.
- BC30I The Board noted that the definition of 'material' in paragraph 7 of IAS 1 discusses omissions or misstatements of items being material if they could individually or collectively influence economic decisions. The Board considered making amendments to paragraph 31 of IAS 1 to say that an entity need not provide a specific disclosure if the information provided by that disclosure is not material, either individually or collectively. However, the Board decided not to make that change since the definition of material already incorporates the notions of individual and collective assessment and, therefore, reference to the term material in paragraph 31 is sufficient to incorporate this concept.
- BC30J In the March 2014 Exposure Draft the Board proposed to use the term 'present' to refer to line items, subtotals and totals on the statement(s) of profit or loss and other comprehensive income, the statement of financial position, the statement of cash flows and the statement of changes in equity, and the term 'disclose' to mean information in the notes. However, respondents to the March 2014 Exposure Draft did not support the distinction between present and disclose because they considered that the terminology has not been used consistently throughout IAS 1 and that any changes in how these terms are used should be done as part of a comprehensive review of IAS 1. Because of this, and because making such comprehensive changes to IAS 1 would be outside the scope of these amendments, the Board did not finalise the proposed changes regarding use of the terms present and disclose.

Comparative information

A statement of financial position as at the beginning of the earliest comparative period (paragraph 39)

- BC31 The exposure draft of 2006 proposed that a statement of financial position as at the beginning of the earliest comparative period should be presented as part of a complete set of financial statements. This statement would provide a basis for investors and creditors to evaluate information about the entity's performance during the period. However, many respondents expressed concern that the requirement would unnecessarily increase disclosures in financial statements, or would be impracticable, excessive and costly.
- BC32 By adding a statement of financial position as at the beginning of the earliest comparative period, the exposure draft proposed that an entity should present three statements of financial position and two of each of the other statements. Considering that financial statements from prior years are readily available for financial analysis, the Board decided to require only two statements of financial position, except when the financial statements have been affected by retrospective application or retrospective restatement, as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, or when a reclassification has been made. In those circumstances three statements of financial position are required.

Clarification of requirements for comparative information

- BC32A In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed a request to clarify the requirements for providing comparative information for:
- (a) the comparative requirements for the opening statement of financial position when an entity changes accounting policies, or makes retrospective restatements or reclassifications, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; and
 - (b) the requirements for providing comparative information when an entity provides financial statements beyond the minimum comparative information requirements.

Opening statement of financial position

- BC32B In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed a request to clarify the appropriate date for the opening statement of financial position. The Board decided to amend the current requirements in IAS 1 that relate to the presentation of a statement of financial position for the beginning of the earliest comparative period presented in cases of changes in accounting policies, retrospective restatements or reclassifications to clarify that the appropriate date for the opening statement of financial position is the beginning of the preceding period.
- BC32C The Board also decided to change the previous requirements so that related notes to this opening statement of financial position are no longer required to be presented. The Board's decision to give this relief was based on the fact that circumstances in which an entity changes an accounting policy, or makes a retrospective restatement or a reclassification in accordance with IAS 8, are considered narrow, specific and limited. However, the circumstances in which an entity chooses to provide additional financial statements (ie on a voluntary basis) can be viewed as more generic and may arise for different reasons. Accordingly, this relief is not available when additional financial statements are provided on a voluntary basis.
- BC32D The Board added the guidance in paragraph 40A(a) to clarify when an opening statement of financial position provides useful information and, should therefore be required. Paragraph 40A(b) is a reminder that the concept of materiality should be considered in applying the guidance in paragraph 40A(a). The Board noted that the entity would still be

required to disclose the information required by IAS 8 for changes in accounting policies and retrospective restatements.

Comparative information beyond minimum requirements

BC32E In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed a request to clarify the requirements for providing comparative information. Specifically, the Board was asked to consider whether an entity should be required to present a complete set of financial statements when it provides financial statements beyond the minimum comparative information requirements (ie additional comparative information). In response to this request, the Board decided to clarify that additional financial statement information need not be presented in the form of a complete set of financial statements for periods beyond the minimum requirements. The Board also noted that additional comparative information might include:

- (a) information that is presented voluntarily, beyond the information that is included within a complete set of financial statements; or
- (b) comparative information that is required by law or other regulations but that is not required by IFRSs.

BC32F The Board also decided to amend paragraphs 38–41 of IAS 1 to clarify that, when additional comparative information (that is not required by IFRSs) is provided by an entity, this information should be presented in accordance with IFRSs and the entity should present comparative information in the related notes for that additional information. The Board determined that requiring full notes for additional information in accordance with paragraph 38C is necessary to ensure that the additional information that the entity provides is balanced and results in financial statements that achieve a fair presentation.

BC32G In the light of the concerns raised by interested parties, the Board decided that the amendments should be introduced through the Annual Improvements process instead of through the Financial Statement Presentation project, so that the changes could be made more quickly.

IAS 34 *Interim Financial Reporting*

BC33 The Board decided not to reflect in paragraph 8 of IAS 34 (ie the minimum components of an interim financial report) its decision to require the inclusion of a statement of financial position as at the beginning of the earliest comparative period in a complete set of financial statements. IAS 34 has a year-to-date approach to interim reporting and does not replicate the requirements of IAS 1 in terms of comparative information.

Criterion for exemption from requirements (paragraphs 41–44)

BC34 IAS 1 as issued in 1997 specified that when the presentation or classification of items in the financial statements is amended, comparative amounts should be reclassified unless it is impracticable to do so. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

BC35 The exposure draft of 2002 proposed a different criterion for exemption from particular requirements. For the reclassification of comparative amounts, and its proposed new requirement to disclose key assumptions and other sources of estimation uncertainty at the end of the reporting period (discussed in paragraphs BC79–BC84), the exposure draft proposed that the criterion for exemption should be that applying the requirements would require undue cost or effort.

- BC36 In the light of respondents' comments on the exposure draft, the Board decided that an exemption based on management's assessment of undue cost or effort was too subjective to be applied consistently by different entities. Moreover, balancing costs and benefits was a task for the Board when it sets accounting requirements rather than for entities when they apply them. Therefore, the Board retained the 'impracticability' criterion for exemption. This affects the exemptions now set out in paragraphs 41–43 and 131 of IAS 1. Impracticability is the only basis on which IFRSs allow specific exemptions from applying particular requirements when the effect of applying them is material*.

Reporting owner and non-owner changes in equity

- BC37 The exposure draft of 2006 proposed to separate changes in equity of an entity during a period arising from transactions with owners in their capacity as owners (ie all owner changes in equity) from other changes in equity (ie non-owner changes in equity). All owner changes in equity would be presented in the statement of changes in equity, separately from non-owner changes in equity.
- BC38 Most respondents welcomed this proposal and saw this change as an improvement of financial reporting, by increasing the transparency of those items recognised in equity that are not reported as part of profit or loss. However, some respondents pointed out that the terms 'owner' and 'non-owner' were not defined in the exposure draft, the *Framework* or elsewhere in IFRSs, although they are extensively used in national accounting standards. They also noted that the terms 'owner' and 'equity holder' were used interchangeably in the exposure draft. The Board decided to adopt the term 'owner' and use it throughout IAS 1 to converge with SFAS 130, which uses the term in the definition of 'comprehensive income'.

Statement of financial position

Information to be presented in the statement of financial position (paragraphs 54–55A)

- BC38A Paragraph 54 of IAS 1 lists line items that are required to be presented in the statement of financial position. The Board has been informed that some have interpreted that list as prescriptive and that those line items cannot be disaggregated. There is also a perception by some that IFRS prevents them from presenting subtotals in addition to those specifically required by IFRS.
- BC38B Paragraph 55 of IAS 1 requires an entity to present additional line items, headings and subtotals when their presentation is relevant to an understanding of the entity's financial position. This highlights that the line items listed for presentation in paragraph 54 of IAS 1 should be disaggregated and that subtotals should be presented, when relevant. Paragraphs 78 and 98 of IAS 1 give examples of potential disaggregations of line items in the statement of financial position and the statement(s) of profit or loss and other comprehensive income.
- BC38C Consequently, the Board:
- (a) removed the wording 'as a minimum' from paragraph 54 of IAS 1 (see paragraph BC30D) to address the possible misconception that this wording prevents entities from aggregating the line items specified in paragraph 54 if those specified line items are immaterial; and
 - (b) clarified that the presentation requirements in paragraphs 54–55 may be fulfilled by disaggregating a specified line item.

* In 2006 the IASB issued IFRS 8 *Operating Segments*. As explained in paragraphs BC46 and BC47 of the Basis for Conclusions on IFRS 8, that IFRS includes an exemption from some requirements if the necessary information is not available and the cost to develop it would be excessive.

BC38D The Board noted that there are similar presentation requirements in paragraph 85 of IAS 1 for the statement(s) of profit or loss and other comprehensive income. The Board therefore amended those requirements to make them consistent.

BC38E Some respondents to the proposals suggested that the Board should make clear that the line items listed in paragraph 54 of IAS 1 are required 'when material'. The Board decided not to state that the line items are only required when material, because materiality is generally not referenced specifically in disclosure requirements in IFRS and so including a specific reference in this case could make it less clear that materiality applies to other disclosure requirements.

BC38F The Board understands that some are concerned about the presentation of subtotals, in addition to those specified in IFRS, in the statement of financial position and the statement(s) of profit or loss and other comprehensive income. Those with this concern think that some subtotals can be misleading, for example, because they are given undue prominence. The Board noted that paragraphs 55 and 85 of IAS 1 require the presentation of subtotals when such presentation is relevant to an understanding of the entity's financial position or financial performance.

BC38G The Board therefore included additional requirements in IAS 1 to help entities apply paragraphs 55 and 85. These additional requirements supplement the existing guidance on fair presentation in paragraphs 15 and 17 of IAS 1. They are designed to clarify the factors that should be considered when fairly presenting subtotals in the statement of financial position and the statement(s) of profit or loss and other comprehensive income. Specifically, the subtotal should:

- (a) be comprised of line items made up of amounts recognised and measured in accordance with IFRS.
- (b) be understandable. It should be clear what line items are included in the subtotal by the way that the subtotal is presented and labelled. For example, if an entity presents a commonly reported subtotal, but excludes items that would normally be considered as part of that subtotal, the label should reflect what has been excluded.
- (c) be consistent from period to period. The subtotal should be consistently presented and calculated from period to period (in accordance with paragraph 45 of IAS 1), subject to possible changes in accounting policy or estimates assessed in accordance with IAS 8.
- (d) not be displayed with more prominence than those subtotals and totals required in IFRS for either the statement(s) of profit or loss and other comprehensive income or the statement of financial position.

Current assets and current liabilities (paragraphs 68 and 71)

BC38H As part of its improvements project in 2007, the Board identified inconsistent guidance regarding the current/non-current classification of derivatives. Some might read the guidance included in paragraph 71 as implying that financial liabilities classified as held for trading in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* are always required to be presented as current.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued

- BC38I The Board expects the criteria set out in paragraph 69 to be used to assess whether a financial liability should be presented as current or non-current. The 'held for trading' category in paragraph 9 of IAS 39^{*} is for measurement purposes and includes financial assets and liabilities that may not be held primarily for trading purposes.
- BC38J The Board reaffirmed that if a financial liability is held primarily for trading purposes it should be presented as current regardless of its maturity date. However, a financial liability that is not held for trading purposes, such as a derivative that is not a financial guarantee contract or a designated hedging instrument, should be presented as current or non-current on the basis of its settlement date. For example, derivatives that have a maturity of more than twelve months and are expected to be held for more than twelve months after the reporting period should be presented as non-current assets or liabilities.
- BC38K Therefore, the Board decided to remove the identified inconsistency by amending the examples of current liabilities in paragraph 71. The Board also amended paragraph 68 in respect of current assets to remove a similar inconsistency.

Classification of the liability component of a convertible instrument (paragraph 69)

- BC38L As part of its improvements project in 2007, the Board considered the classification of the liability component of a convertible instrument as current or non-current. Paragraph 69(d) of IAS 1 states that when an entity does not have an unconditional right to defer settlement of a liability for at least twelve months after the reporting period, the liability should be classified as current. According to the *Framework*, conversion of a liability into equity is a form of settlement.
- BC38M The application of these requirements means that if the conversion option can be exercised by the holder at any time, the liability component would be classified as current. This classification would be required even if the entity would not be required to settle unconverted instruments with cash or other assets for more than twelve months after the reporting period.
- BC38N IAS 1 and the *Framework* state that information about the liquidity and solvency positions of an entity is useful to users. The terms 'liquidity' and 'solvency' are associated with the availability of cash to an entity. Issuing equity does not result in an outflow of cash or other assets of the entity.
- BC38O The Board concluded that classifying the liability on the basis of the requirements to transfer cash or other assets rather than on settlement better reflects the liquidity and solvency position of an entity, and therefore it decided to amend IAS 1 accordingly.
- BC38P The Board discussed the comments received in response to its exposure draft of proposed Improvements to IFRSs published in 2007 and noted that some respondents were concerned that the proposal in the exposure draft would apply to all liabilities, not just those that are components of convertible instruments as originally contemplated in the exposure draft. Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended the proposed wording to clarify that the amendment applies only to the classification of a liability that can, at the option of the counterparty, be settled by the issue of the entity's equity instruments.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued

Effect of events after the reporting period on the classification of liabilities (paragraphs 69–76)

BC39 Paragraph 63 of IAS 1 (as issued in 1997) included the following:

An enterprise should continue to classify its long-term interest-bearing liabilities as non-current, even when they are due to be settled within twelve months of the balance sheet date if:

- (a) the original term was for a period of more than twelve months;
- (b) the enterprise intends to refinance the obligation on a long-term basis; and
- (c) that intention is supported by an agreement to refinance, or to reschedule payments, which is completed before the financial statements are authorised for issue.

BC40 Paragraph 65 stated:

Some borrowing agreements incorporate undertakings by the borrower (covenants) which have the effect that the liability becomes payable on demand if certain conditions related to the borrower's financial position are breached. In these circumstances, the liability is classified as non-current only when:

- (a) the lender has agreed, prior to the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach; and
- (b) it is not probable that further breaches will occur within twelve months of the balance sheet date.

BC41 The Board considered these requirements and concluded that refinancing, or the receipt of a waiver of the lender's right to demand payment, that occurs after the reporting period should not be taken into account in the classification of a liability.

BC42 Therefore, the exposure draft of 2002 proposed:

- (a) to amend paragraph 63 to specify that a long-term financial liability due to be settled within twelve months of the balance sheet date should not be classified as a non-current liability because an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue. This amendment would not affect the classification of a liability as non-current when the entity has, under the terms of an existing loan facility, the discretion to refinance or roll over its obligations for at least twelve months after the balance sheet date.
- (b) to amend paragraph 65 to specify that a long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date even if the lender has agreed after the balance sheet date, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach. However, if the lender has agreed by the balance sheet date to provide a period of grace within which the entity can rectify the breach and during which the lender cannot demand immediate repayment, the liability is classified as non-current if it is due for settlement, without that breach of the loan agreement, at least twelve months after the balance sheet date and:
 - (i) the entity rectifies the breach within the period of grace; or
 - (ii) when the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified.

- BC43 Some respondents disagreed with these proposals. They advocated classifying a liability as current or non-current according to whether it is expected to use current assets of the entity, rather than strictly on the basis of its date of maturity and whether it is callable at the end of the reporting period. In their view, this would provide more relevant information about the liability's future effect on the timing of the entity's resource flows.
- BC44 However, the Board decided that the following arguments for changing paragraphs 63 and 65 were more persuasive:
- (a) refinancing a liability after the balance sheet date does not affect the entity's liquidity and solvency *at the balance sheet date*, the reporting of which should reflect contractual arrangements in force on that date. Therefore, it is a non-adjusting event in accordance with IAS 10 *Events after the Balance Sheet Date* and should not affect the presentation of the entity's balance sheet.
 - (b) it is illogical to adopt a criterion that 'non-current' classification of short-term obligations expected to be rolled over for at least twelve months after the balance sheet date depends on whether the rollover is at the discretion of the entity, and then to provide an exception based on refinancing occurring after the balance sheet date.
 - (c) in the circumstances set out in paragraph 65, unless the lender has waived its right to demand immediate repayment or granted a period of grace within which the entity may rectify the breach of the loan agreement, the financial condition of the entity at the balance sheet date was that the entity did not hold an absolute right to defer repayment, based on the terms of the loan agreement. The granting of a waiver or a period of grace changes the terms of the loan agreement. Therefore, an entity's receipt from the lender, after the balance sheet date, of a waiver or a period of grace of at least twelve months does not change the nature of the liability to non-current until it occurs.
- BC45 IAS 1 now includes the amendments proposed in 2002, with one change. The change relates to the classification of a long-term loan when, at the end of the reporting period, the lender has provided a period of grace within which a breach of the loan agreement can be rectified, and during which period the lender cannot demand immediate repayment of the loan.
- BC46 The exposure draft proposed that such a loan should be classified as non-current if it is due for settlement, without the breach, at least twelve months after the balance sheet date and:
- (a) the entity rectifies the breach within the period of grace; or
 - (b) when the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified.
- BC47 After considering respondents' comments, the Board decided that the occurrence or probability of a rectification of a breach after the reporting period is irrelevant to the conditions existing at the end of the reporting period. The revised IAS 1 requires that, for the loan to be classified as non-current, the period of grace must end at least twelve months after the reporting period (see paragraph 75). Therefore, the conditions (a) and (b) in paragraph BC46 are redundant.
- BC48 The Board considered arguments that if a period of grace to remedy a breach of a long-term loan agreement is provided before the end of the reporting period, the loan should be classified as non-current regardless of the length of the period of grace. These arguments are based on the view that, at the end of the reporting period, the lender does not have an unconditional legal right to demand repayment before the original maturity date (ie if the entity remedies the breach during the period of grace, it is entitled to repay the loan on the original maturity date). However, the Board concluded that an entity should

classify a loan as non-current only if it has an unconditional right to defer settlement of the loan for at least twelve months after the reporting period. This criterion focuses on the legal rights of the entity, rather than those of the lender.

Statement of comprehensive income

Reporting comprehensive income (paragraph 81)

- BC49 The exposure draft of 2006 proposed that all non-owner changes in equity should be presented in a single statement or in two statements. In a single-statement presentation, all items of income and expense are presented together. In a two-statement presentation, the first statement ('income statement') presents income and expenses recognised in profit or loss and the second statement ('statement of comprehensive income') begins with profit or loss and presents, in addition, items of income and expense that IFRSs require or permit to be recognised outside profit or loss. Such items include, for example, translation differences related to foreign operations and gains or losses on available-for-sale financial assets.* The statement of comprehensive income does not include transactions with owners in their capacity as owners. Such transactions are presented in the statement of changes in equity.
- BC50 Respondents to the exposure draft had mixed views about whether the Board should permit a choice of displaying non-owner changes in equity in one statement or two statements. Many respondents agreed with the Board's proposal to maintain the two-statement approach and the single-statement approach as alternatives and a few urged the Board to mandate one of them. However, most respondents preferred the two-statement approach because it distinguishes profit or loss and total comprehensive income; they believe that with the two-statement approach, the 'income statement' remains a primary financial statement. Respondents supported the presentation of two separate statements as a transition measure until the Board develops principles to determine the criteria for inclusion of items in profit or loss or in other comprehensive income.
- BC51 The exposure draft of 2006 expressed the Board's preference for a single statement of all non-owner changes in equity. The Board provided several reasons for this preference. All items of non-owner changes in equity meet the definitions of income and expenses in the *Framework*. The *Framework* does not define profit or loss, nor does it provide criteria for distinguishing the characteristics of items that should be included in profit or loss from those items that should be excluded from profit or loss. Therefore, the Board decided that it was conceptually correct for an entity to present all non-owner changes in equity (ie all income and expenses recognised in a period) in a single statement because there are no clear principles or common characteristics that can be used to separate income and expenses into two statements.
- BC52 However, in the Board's discussions with interested parties, it was clear that many were strongly opposed to the concept of a single statement. They argued that there would be undue focus on the bottom line of the single statement. In addition, many argued that it was premature for the Board to conclude that presentation of income and expense in a single statement was an improvement in financial reporting without also addressing the other aspects of presentation and display, namely deciding what categories and line items should be presented in a statement of recognised income and expense.
- BC53 In the light of these views, although it preferred a single statement, the Board decided that an entity should have the choice of presenting all income and expenses recognised in a period in one statement or in two statements. An entity is prohibited from presenting components of income and expense (ie non-owner changes in equity) in the statement of changes in equity.

* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

- BC54 Many respondents disagreed with the Board's preference and thought that a decision at this stage would be premature. In their view the decision about a single-statement or two-statement approach should be subject to further consideration. They urged the Board to address other aspects of presentation and display, namely deciding which categories and line items should be presented in a 'statement of comprehensive income'. The Board reaffirmed its reasons for preferring a single-statement approach and agreed to address other aspects of display and presentation in the next stage of the project.
- BC54A In *Presentation of Items of Other Comprehensive Income* published in May 2010 the Board proposed to eliminate the option to present all items of income and expense recognised in a period in two statements, thereby requiring presentation in a continuous statement displaying two sections: *profit or loss* and *other comprehensive income*. The Board also proposed to require items of OCI to be classified into items that might be reclassified (recycled) to profit or loss in subsequent periods and items that would not be reclassified subsequently.
- BC54B In its deliberations on financial instruments and pensions the Board discussed the increasing importance of consistent presentation of items of OCI. Both projects will increase the number of items presented in OCI, particularly items that will not be reclassified subsequently to profit or loss. Therefore the Board thought it important that all income and expenses that are components of the total non-owner changes in equity should be presented transparently.
- BC54C The Board has no plans to eliminate profit or loss as a measure of performance. Profit or loss will be presented separately and will remain the required starting point for the calculation of earnings per share.
- BC54D The Board had previously received responses to similar proposals for a single statement of comprehensive income. In October 2008 the Board and the FASB jointly published a discussion paper, *Preliminary Views on Financial Statement Presentation*. In that paper, the boards proposed eliminating the alternative presentation formats for comprehensive income and to require an entity to present comprehensive income and its components in a single statement. The boards asked for views on that proposal. The responses were split on whether an entity should present comprehensive income and its components in a single statement or in two separate statements. In general, respondents supporting a single statement of comprehensive income said that it would lead to greater transparency, consistency and comparability. Furthermore, the process of calculating financial ratios would be made easier.
- BC54E Respondents disagreeing with the proposal for a single statement of comprehensive income urged the boards to defer any changes to the guidance on the statement of comprehensive income until the boards had completed a project to revise the guidance on what items should be presented in OCI. Those respondents also said that a single statement would undermine the importance of profit or loss by making it a subtotal and that presenting total comprehensive income as the last number in the statement would confuse users. They also feared that requiring all items of income and expense to be presented in a single statement was the first step by the boards towards eliminating the notion of profit or loss. In addition, they argued that the items that are presented in OCI are different from items presented in profit or loss. Therefore they preferred either to keep the presentation of profit or loss separate from the presentation of OCI or to allow management to choose to present them either in a single statement or in two statements.
- BC54F In the responses to the exposure draft of May 2010 many of the respondents objected to the proposals to remove the option to present all items of income and expense in two statements. The arguments used by those objecting were much the same as those received on the discussion paper. However, many respondents, regardless of their views on the proposed amendments, said that the Board should establish a conceptual basis for what should be presented in OCI. Those opposed to a continuous statement cited OCI's lack of a conceptual definition and therefore believed that OCI should not be presented in close proximity to profit or loss because this would confuse users. However, users

generally said that the lack of a conceptual framework made it difficult to distinguish the underlying economics of items reported in profit or loss (net income) from items reported in other comprehensive income. Although users also asked for a conceptual framework for OCI, most supported the notion of a single statement of comprehensive income.

BC54G Another issue on which many respondents commented was the reclassification (recycling) of OCI items. Those respondents said that in addition to addressing the conceptual basis for the split between profit or loss and OCI the Board should set principles for which OCI items should be reclassified (recycled) to profit or loss and when they should be reclassified. The Board acknowledges that it has not set out a conceptual basis for how it determines whether an item should be presented in OCI or in profit or loss. It also agrees that it has not set out principles to determine whether items should be reclassified to profit or loss. Those matters were not within the scope of this project, which focused on presentation, and therefore the Board has not addressed them at this time. However, the Board is consulting on its future agenda, which could lead to those matters becoming part of the work programme.

BC54H In the light of the response the Board confirmed in June 2011 the requirement for items of OCI to be classified into items that will not be reclassified (recycled) to profit or loss in subsequent periods and items that might be reclassified.

BC54I The Board also decided not to mandate the presentation of profit or loss in a continuous statement of profit or loss and other comprehensive income but to maintain an option to present two statements. The Board did this in the light of the negative response to its proposal for a continuous statement and the resistance to this change signified by a majority of respondents.

BC54J The FASB also proposed in its exposure draft to mandate a continuous statement of comprehensive income but decided in the light of the responses not to go as far as mandating a single statement and instead to allow the two-statement option. Nevertheless, the changes made by the FASB are a significant improvement for US GAAP, which previously allowed an option to present OCI items in stockholders' equity or in the notes to the financial statements.

BC54K In 2013 the IFRS Interpretations Committee reported to the Board that there was uncertainty about the requirements in paragraph 82A of IAS 1 for presenting an entity's share of items of other comprehensive income of associates and joint ventures accounted for using the equity method. The Board agreed that paragraph 82A allowed for diverse interpretations, and therefore decided to amend IAS 1 as follows:

- (a) to clarify that paragraph 82A requires entities to present the share of other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that:
 - (i) will not be reclassified subsequently to profit or loss; and
 - (ii) will be reclassified subsequently to profit or loss when specific conditions are met.
- (b) to amend the Guidance on Implementing IAS 1 to reflect the clarification of paragraph 82A.

The Board noted that whether an amount is reclassified to profit or loss is determined by the nature of the underlying item. It also noted that the timing of reclassification is usually determined by the actions of the investee. It may however also be triggered by the investor, which would be the case on the disposal of the investee by the investor.

- BC54L The feedback received on the March 2014 Exposure Draft included requests for the Board to clarify whether the investor's share of the other comprehensive income of its associate or joint venture should be presented net or gross of tax and the applicability of the guidance in paragraphs 90–91 of IAS 1 in this regard. The Board noted that an investor's share of other comprehensive income of associates or joint ventures is after tax and non-controlling interests of the associate or joint venture, as illustrated in the Guidance on Implementing IAS 1. It also noted that the disclosure requirements in paragraphs 90–91 do not apply to the tax of the associate or joint venture that is already reflected in the investor's share of other comprehensive income of the associate or joint venture. However, the Board noted that if the investor itself is liable for tax in respect of its share of other comprehensive income of the associate or joint venture, then paragraphs 90–91 would apply to this tax. Therefore, the Board decided not to add additional guidance to IAS 1 on this topic.

Results of operating activities

- BC55 IAS 1 omits the requirement in the 1997 version to disclose the results of operating activities as a line item in the income statement. 'Operating activities' are not defined in IAS 1, and the Board decided not to require disclosure of an undefined item.
- BC56 The Board recognises that an entity may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating'. In the Board's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.

Subtotal for profit or loss (paragraph 82)

- BC57 As revised, IAS 1 requires a subtotal for profit or loss in the statement of comprehensive income. If an entity chooses to present comprehensive income by using two statements, it should begin the second statement with profit or loss—the bottom line of the first statement (the 'income statement')—and display the components of other comprehensive income immediately after that. The Board concluded that this is the best way to achieve the objective of equal prominence (see paragraph BC22) for the presentation of income and expenses. An entity that chooses to display comprehensive income in one statement should include profit or loss as a subtotal within that statement.
- BC58 The Board acknowledged that the items included in profit or loss do not possess any unique characteristics that allow them to be distinguished from items that are included in other comprehensive income. However, the Board and its predecessor have required some items to be recognised outside profit or loss. The Board will deliberate in the next stage of the project how items of income and expense should be presented in the statement of comprehensive income.

Information to be presented in the profit or loss section or the statement of profit or loss (paragraphs 85–85B)

- BC58A In December 2014 the Board issued *Disclosure Initiative* (Amendments to IAS 1). Those amendments included amendments to paragraph 85 of IAS 1 and the addition of paragraph 85A. These amendments are consistent with similar amendments to the requirements for the statement of financial position and therefore the Basis for Conclusions for these amendments has been included in the section dealing with that statement (see paragraphs BC38A–BC38G).

BC58B In addition to those amendments, the Board decided to require entities to present line items in the statement(s) of profit or loss and other comprehensive income that reconcile any subtotals presented in accordance with paragraphs 85–85A of IAS 1 with those that are required in IFRS for the statement(s) of profit or loss and other comprehensive income. Consequently, it added paragraph 85B to IAS 1. The purpose of this requirement is to help users of financial statements understand the relationship between the subtotals presented in accordance with paragraph 85 and the specific totals and subtotals required in IFRS to address concerns that that relationship would not be clear. The Board noted that such a requirement is already implicit in existing IFRS requirements. IFRS requires entities to present aggregated information as line items when such presentation provides material information. Consequently, because all recognised items of income and expense must be included in the statement(s) of profit or loss and other comprehensive income totals, any intervening line items and subtotals necessarily reconcile. However, the Board decided to make the requirement more explicit for the statement(s) of profit or loss and other comprehensive income to help users of financial statements understand the relationship between subtotals and totals presented in the statement(s) of profit or loss and other comprehensive income.

Minority interest (paragraph 83)*

BC59 IAS 1 requires the ‘profit or loss attributable to minority interest’ and ‘profit or loss attributable to owners of the parent’ each to be presented in the income statement in accordance with paragraph 83. These amounts are to be presented as allocations of profit or loss, not as items of income or expense. A similar requirement has been added for the statement of changes in equity, in paragraph 106(a). These changes are consistent with IAS 27 *Consolidated and Separate Financial Statements*, which requires that in a consolidated balance sheet (now called ‘statement of financial position’), minority interest is presented within equity because it does not meet the definition of a liability in the *Framework*.

Extraordinary items (paragraph 87)

BC60 IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* (issued in 1993) required extraordinary items to be disclosed in the income statement separately from the profit or loss from ordinary activities. That standard defined ‘extraordinary items’ as ‘income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly’.

BC61 In 2002, the Board decided to eliminate the concept of extraordinary items from IAS 8 and to prohibit the presentation of items of income and expense as ‘extraordinary items’ in the income statement and the notes. Therefore, in accordance with IAS 1, no items of income and expense are to be presented as arising from outside the entity’s ordinary activities.

BC62 Some respondents to the exposure draft of 2002 argued that extraordinary items should be presented in a separate component of the income statement because they are clearly distinct from all of the other items of income and expense, and because such presentation highlights to users of financial statements the items of income and expense to which the least attention should be given when predicting an entity’s future performance.

* In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended ‘minority interest’ to ‘non-controlling interests’. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The term ‘non-controlling interests’ and the requirements for non-controlling interests were not changed.

- BC63 The Board decided that items treated as extraordinary result from the normal business risks faced by an entity and do not warrant presentation in a separate component of the income statement. The nature or function of a transaction or other event, rather than its frequency, should determine its presentation within the income statement. Items currently classified as 'extraordinary' are only a subset of the items of income and expense that may warrant disclosure to assist users in predicting an entity's future performance.
- BC64 Eliminating the category of extraordinary items eliminates the need for arbitrary segregation of the effects of related external events—some recurring and others not—on the profit or loss of an entity for a period. For example, arbitrary allocations would have been necessary to estimate the financial effect of an earthquake on an entity's profit or loss if it occurs during a major cyclical downturn in economic activity. In addition, paragraph 97 of IAS 1 requires disclosure of the nature and amount of material items of income and expense.

Other comprehensive income—related tax effects (paragraphs 90 and 91)

- BC65 The exposure draft of 2006 proposed to allow components of 'other recognised income and expense' (now 'other comprehensive income') to be presented before tax effects ('gross presentation') or after their related tax effects ('net presentation'). The 'gross presentation' facilitated the traceability of other comprehensive income items to profit or loss, because items of profit or loss are generally displayed before tax. The 'net presentation' facilitated the identification of other comprehensive income items in the equity section of the statement of financial position. A majority of respondents supported allowing both approaches. The Board reaffirmed its conclusion that components of other comprehensive income could be displayed either (a) net of related tax effects or (b) before related tax effects.
- BC66 Regardless of whether a pre-tax or post-tax display was used, the exposure draft proposed to require disclosure of the amount of income tax expense or benefit allocated separately to individual components of other comprehensive income, in line with SFAS 130. Many respondents agreed in principle with this disclosure, because they agreed that it helped to improve the clarity and transparency of such information, particularly when components of other comprehensive income are taxed at rates different from those applied to profit or loss.
- BC67 However, most respondents expressed concern about having to trace the tax effect for each one of the components of other comprehensive income. Several observed that the tax allocation process is arbitrary (eg it may involve the application of subjectively determined tax rates) and some pointed out that this information is not readily available for some industries (eg the insurance sector), where components of other comprehensive income are multiple and tax allocation involves a high degree of subjectivity. Others commented that they did not understand why tax should be attributed to components of comprehensive income line by line, when this is not a requirement for items in profit or loss.
- BC68 The Board decided to maintain the disclosure of income tax expense or benefit allocated to each component of other comprehensive income. Users of financial statements often requested further information on tax amounts relating to components of other comprehensive income, because tax rates often differed from those applied to profit or loss. The Board also observed that an entity should have such tax information available and that a disclosure requirement would therefore not involve additional cost for preparers of financial statements.

BC68A In its exposure draft *Presentation of Items of Other Comprehensive Income* published in May 2010 the Board proposed requiring that income tax on items presented in OCI should be allocated between items that will not be subsequently reclassified to profit or loss and those that might be reclassified, if the items in OCI are presented before tax. Most respondents agreed with this proposal as this would be in line with the existing options in IAS 1 regarding presentation of income tax on OCI items. Therefore the Board confirmed the proposal in June 2011.

Reclassification adjustments (paragraphs 92–96)

- BC69 In the exposure draft of 2006, the Board proposed that an entity should separately present reclassification adjustments. These adjustments are the amounts reclassified to profit or loss in the current period that were previously recognised in other comprehensive income. The Board decided that adjustments necessary to avoid double-counting items in total comprehensive income when those items are reclassified to profit or loss in accordance with IFRSs. The Board's view was that separate presentation of reclassification adjustments is essential to inform users of those amounts that are included as income and expenses in different periods—as income or expenses in other comprehensive income in previous periods and as income or expenses in profit or loss in the current period. Without such information, users may find it difficult to assess the effect of reclassifications on profit or loss and to calculate the overall gain or loss associated with available-for-sale financial assets*, cash flow hedges and on translation or disposal of foreign operations.
- BC70 Most respondents agreed with the Board's decision and believe that the disclosure of reclassification adjustments is important to understanding how components recognised in profit or loss are related to other items recognised in equity in two different periods. However, some respondents suggested that the Board should use the term 'recycling', rather than 'reclassification' as the former term is more common. The Board concluded that both terms are similar in meaning, but decided to use the term 'reclassification adjustment' to converge with the terminology used in SFAS 130.
- BC71 The exposure draft proposed to allow the presentation of reclassification adjustments in the statement of recognised income and expense (now 'statement of comprehensive income') or in the notes. Most respondents supported this approach.
- BC72 Some respondents noted some inconsistencies in the definition of 'reclassification adjustments' in the exposure draft (now paragraphs 7 and 93 of IAS 1). Respondents suggested that the Board should expand the definition in paragraph 7 to include gains and losses recognised in current periods in addition to those recognised in earlier periods, to make the definition consistent with paragraph 93. They commented that, without clarification, there could be differences between interim and annual reporting, for reclassifications of items that arise in one interim period and reverse out in a different interim period within the same annual period.
- BC73 The Board decided to align the definition of reclassification adjustments with SFAS 130 and include an additional reference to 'current periods' in paragraph 7.

Statement of changes in equity

Effects of retrospective application or retrospective restatement (paragraph 106(b))

- BC74 Some respondents to the exposure draft of 2006 asked the Board to clarify whether the effects of retrospective application or retrospective restatement, as defined in IAS 8, should be regarded as non-owner changes in equity. The Board noted that IAS 1 specifies that

* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

these effects are included in the statement of changes in equity. However, the Board decided to clarify that the effects of retrospective application or retrospective restatement are not changes in equity in the period, but provide a reconciliation between the previous period's closing balance and the opening balance in the statement of changes in equity.

Reconciliation for each component of other comprehensive income (paragraphs 106(d)(ii) and 106A)

BC74A Paragraph 106(d) requires an entity to provide a reconciliation of changes in each component of equity. In *Improvements to IFRSs* issued in May 2010, the Board clarified that entities may present the required reconciliations for each component of other comprehensive income either in the statement of changes in equity or in the notes to the financial statements.

Presentation of dividends (paragraph 107)

BC75 The Board reaffirmed its conclusion to require the presentation of dividends in the statement of changes in equity or in the notes, because dividends are distributions to owners in their capacity as owners and the statement of changes in equity presents all owner changes in equity. The Board concluded that an entity should not present dividends in the statement of comprehensive income because that statement presents non-owner changes in equity.

Statement of cash flows

IAS 7 Cash Flow Statements (paragraph 111)

BC76 The Board considered whether the operating section of an indirect method statement of cash flows should begin with total comprehensive income instead of profit or loss as is required by IAS 7 *Cash Flow Statements*. When components of other comprehensive income are non-cash items, they would become reconciling items in arriving at cash flows from operating activities and would add items to the statement of cash flows without adding information content. The Board concluded that an amendment to IAS 7 is not required; however, as mentioned in paragraph BC14 the Board decided to relabel this financial statement as 'statement of cash flows'.

Notes

Structure (paragraphs 112–116)

BC76A The Board is aware that some had interpreted paragraph 114 of IAS 1 as requiring a specific order for the notes. Paragraph 114 stated that 'an entity normally presents notes in the [following] order' and then listed a particular order for the notes. Some think that the use of 'normally' makes it difficult for an entity to vary the order of the notes from the one that is listed in paragraph 114; for example, by disclosing the notes in order of importance or disclosing related information together in sections.

BC76B Investors' feedback indicates that some investors prefer an entity to vary the order of the notes from the one that is listed in paragraph 114 of IAS 1. Other investors would prefer entities to use that order because they think it will increase comparability between periods and across entities.

BC76C The Board considered the use of the word normally in paragraph 114 of IAS 1 and concluded that it was not intended that entities be required to disclose their notes in that order. Instead, it thinks that the order listed was intended to provide an example of how an entity could order the notes and that the term normal was not meant to imply that alternative ordering of the notes is 'abnormal'. The Board therefore amended IAS 1 to clarify that the

order listed in paragraph 114 is an example of how an entity could order or group its notes in a systematic manner. The Board also made amendments to clarify that significant accounting policies do not need to be disclosed in one note, but instead can be included with related information in other notes.

BC76D The Board also noted the requirement in paragraph 113 of IAS 1 for entities to, as far as practicable, present the notes in a systematic manner. In the Board's view, this means that there must be a system or reason behind the ordering and grouping of the notes. For example, notes could be ordered by importance to the entity, in the order line items are presented in the financial statements or a combination of both. The Board amended paragraph 113 to clarify that an entity should consider the effect on the understandability and comparability of its financial statements when determining the order of the notes. The Board acknowledged that there is a trade-off between understandability and comparability; for example, ordering notes to increase understandability could mean that comparability, including consistency, between entities and periods is reduced. In particular, the Board acknowledged that consistency in the order of the notes for a specific entity from period to period is important. The Board noted that it would generally be helpful for users of financial statements if the ordering of notes by an entity is consistent and noted that it does not expect the order of an entity's notes to change frequently. A change in the order of the notes previously determined to be an optimal mix of understandability and comparability should generally result from a specific event or transaction, such as a change in business. The Board also noted that the existing requirements in paragraph 45 of IAS 1 for consistency of presentation still apply.

BC76E The Board also observed that electronic versions of financial statements can make it easier to search for, locate and compare information within the financial statements, between periods and between entities.

Disclosure of accounting policies (paragraphs 117–121)

BC76F Paragraph 117 of IAS 1 requires significant accounting policies to be disclosed and gives guidance, along with paragraphs 118–124 of IAS 1, about what a significant accounting policy could be. That guidance includes, as examples of significant accounting policies, the income taxes accounting policy and the foreign currency accounting policy.

BC76G Some suggested that it is not helpful to provide the income taxes accounting policy as an example of a policy that users of financial statements would expect to be disclosed. Being liable to income taxes is typical for many entities and it was not clear, from the example, what aspect of the entity's operations would make a user of financial statements expect an accounting policy on income taxes to be disclosed. Consequently, the example does not illustrate why an accounting policy on income taxes is significant. The Board also thought that the foreign currency accounting policy example in paragraph 120 of IAS 1 was unhelpful for the same reasons and therefore deleted the income taxes and foreign currency examples.

Disclosure of the judgements that management has made in the process of applying the entity's accounting policies (paragraphs 122–124)

BC77 The revised IAS 1 requires disclosure of the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements (see paragraph 122). An example of these judgements is how management determines whether financial assets are held-to-maturity investments.* The Board decided that disclosure of the most important of these judgements would enable users of financial

* IFRS 9 *Financial Instruments* eliminated the category of held-to-maturity financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

statements to understand better how the accounting policies are applied and to make comparisons between entities regarding the basis on which managements make these judgements.

- BC78 Comments received on the exposure draft of 2002 indicated that the purpose of the proposed disclosure was unclear. Accordingly, the Board amended the disclosure explicitly to exclude judgements involving estimations (which are the subject of the disclosure in paragraph 125) and added another four examples of the types of judgements disclosed (see paragraphs 123 and 124).

Disclosure of major sources of estimation uncertainty (paragraphs 125–133)

- BC79 IAS 1 requires disclosure of the assumptions concerning the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. For those assets and liabilities, the proposed disclosures include details of:
- (a) their nature, and
 - (b) their carrying amount as at the end of the reporting period (see paragraph 125).
- BC80 Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. For example, in the absence of recently observed market prices used to measure the following assets and liabilities, future-oriented estimates are necessary to measure the recoverable amount of classes of property, plant and equipment, the effect of technological obsolescence of inventories, provisions subject to the future outcome of litigation in progress, and long-term employee benefit liabilities such as pension obligations. These estimates involve assumptions about items such as the risk adjustment to cash flows or discount rates used, future changes in salaries and future changes in prices affecting other costs. No matter how diligently an entity estimates the carrying amounts of assets and liabilities subject to significant estimation uncertainty at the end of the reporting period, the reporting of point estimates in the statement of financial position cannot provide information about the estimation uncertainties involved in measuring those assets and liabilities and the implications of those uncertainties for the period's profit or loss.
- BC81 The *Framework* states that 'The economic decisions that are made by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation.' The Board decided that disclosure of information about assumptions and other major sources of estimation uncertainty at the end of the reporting period enhances the relevance, reliability and understandability of the information reported in financial statements. These assumptions and other sources of estimation uncertainty relate to estimates that require management's most difficult, subjective or complex judgements. Therefore, disclosure in accordance with paragraph 125 of the revised IAS 1 would be made in respect of relatively few assets or liabilities (or classes of them).

- BC82 The exposure draft of 2002 proposed the disclosure of some 'sources of measurement uncertainty'. In the light of comments received that the purpose of this disclosure was unclear, the Board decided:
- (a) to amend the subject of that disclosure to 'sources of estimation uncertainty at the end of the reporting period', and
 - (b) to clarify in the revised Standard that the disclosure does not apply to assets and liabilities measured at fair value based on recently observed market prices (see paragraph 128 of IAS 1).
- BC83 When assets and liabilities are measured at fair value on the basis of recently observed market prices, future changes in carrying amounts would not result from using estimates to measure the assets and liabilities at the end of the reporting period. Using observed market prices to measure assets or liabilities obviates the need for estimates at the end of the reporting period. The market prices properly reflect the fair values at the end of the reporting period, even though future market prices could be different. The objective of fair value measurement is to reflect fair value at the measurement date, not to predict a future value*.
- BC84 IAS 1 does not prescribe the particular form or detail of the disclosures. Circumstances differ from entity to entity, and the nature of estimation uncertainty at the end of the reporting period has many facets. IAS 1 limits the scope of the disclosures to items that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. The longer the future period to which the disclosures relate, the greater the range of items that would qualify for disclosure, and the less specific are the disclosures that could be made about particular assets or liabilities. A period longer than the next financial year might obscure the most relevant information with other disclosures.

Disclosures about capital (paragraphs 134 and 135)

- BC85 In July 2004 the Board published an exposure draft—ED 7 *Financial Instruments: Disclosures*. As part of that project, the Board considered whether it should require disclosures about capital.
- BC86 The level of an entity's capital and how it manages capital are important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events. The level of capital might also affect the entity's ability to pay dividends. Consequently, ED 7 proposed disclosures about capital.
- BC87 In ED 7 the Board decided that it should not limit the requirements for disclosures about capital to entities that are subject to external capital requirements (eg regulatory capital requirements established by legislation or other regulation). The Board believes that information about capital is useful for all entities, as is evidenced by the fact that some entities set internal capital requirements and norms have been established for some industries. The Board noted that the capital disclosures are not intended to replace disclosures required by regulators. The Board also noted that the financial statements should not be regarded as a substitute for disclosures to regulators (which may not be available to all users) because the function of disclosures made to regulators may differ from the function of those to other users. Therefore, the Board decided that information about capital should be required of all entities because it is useful to users of general purpose financial statements. Accordingly, the Board did not distinguish between the requirements for regulated and non-regulated entities.

* IFRS 13 *Fair Value Measurement*, issued in May 2011, defined fair value and contains the requirements for measuring fair value.

- BC88 Some respondents to ED 7 questioned the relevance of the capital disclosures in an IFRS dealing with disclosures relating to financial instruments. The Board noted that an entity's capital does not relate solely to financial instruments and, thus, capital disclosures have more general relevance. Accordingly, the Board included these disclosures in IAS 1, rather than IFRS 7 *Financial Instruments: Disclosures*, the IFRS resulting from ED 7.
- BC89 The Board also decided that an entity's decision to adopt the amendments to IAS 1 should be independent of the entity's decision to adopt IFRS 7. The Board noted that issuing a separate amendment facilitates separate adoption decisions.

Objectives, policies and processes for managing capital (paragraph 136)

- BC90 The Board decided that disclosure about capital should be placed in the context of a discussion of the entity's objectives, policies and processes for managing capital. This is because the Board believes that such a discussion both communicates important information about the entity's capital strategy and provides the context for other disclosures.
- BC91 The Board considered whether an entity can have a view of capital that differs from what IFRSs define as equity. The Board noted that, although for the purposes of this disclosure capital would often equate with equity as defined in IFRSs, it might also include or exclude some components. The Board also noted that this disclosure is intended to give entities the opportunity to describe how they view the components of capital they manage, if this is different from what IFRSs define as equity.

Externally imposed capital requirements (paragraph 136)

- BC92 The Board considered whether it should require disclosure of any externally imposed capital requirements. Such a capital requirement could be:
- (a) an industry-wide requirement with which all entities in the industry must comply; or
 - (b) an entity-specific requirement imposed on a particular entity by its prudential supervisor or other regulator.
- BC93 The Board noted that some industries and countries have industry-wide capital requirements, and others do not. Thus, the Board concluded that it should not require disclosure of industry-wide requirements, or compliance with such requirements, because such disclosure would not lead to comparability between different entities or between similar entities in different countries.
- BC94 The Board concluded that disclosure of the existence and level of entity-specific capital requirements is important information for users, because it informs them about the risk assessment of the regulator. Such disclosure improves transparency and market discipline.
- BC95 However, the Board noted the following arguments against requiring disclosure of externally imposed entity-specific capital requirements.
- (a) Users of financial statements might rely primarily on the regulator's assessment of solvency risk without making their own risk assessment.
 - (b) The focus of a regulator's risk assessment is for those whose interests the regulations are intended to protect (eg depositors or policyholders). This emphasis is different from that of a shareholder. Thus, it could be misleading to suggest that the regulator's risk assessment could, or should, be a substitute for independent analysis by investors.

- (c) The disclosure of entity-specific capital requirements imposed by a regulator might undermine that regulator's ability to impose such requirements. For example, the information could cause depositors to withdraw funds, a prospect that might discourage regulators from imposing requirements. Furthermore, an entity's regulatory dialogue would become public, which might not be appropriate in all circumstances.
 - (d) Because different regulators have different tools available, for example formal requirements and moral suasion, a requirement to disclose entity-specific capital requirements could not be framed in a way that would lead to the provision of information that is comparable across entities.
 - (e) Disclosure of capital requirements (and hence, regulatory judgements) could hamper clear communication to the entity of the regulator's assessment by creating incentives to use moral suasion and other informal mechanisms.
 - (f) Disclosure requirements should not focus on entity-specific capital requirements in isolation, but should focus on how entity-specific capital requirements affect how an entity manages and determines the adequacy of its capital resources.
 - (g) A requirement to disclose entity-specific capital requirements imposed by a regulator is not part of Pillar 3 of the Basel II Framework developed by the Basel Committee on Banking Supervision.
- BC96 Taking into account all of the above arguments, the Board decided not to require quantitative disclosure of externally imposed capital requirements. Rather, it decided to require disclosures about whether the entity complied with any externally imposed capital requirements during the period and, if not, the consequences of non-compliance. This retains confidentiality between regulators and the entity, but alerts users to breaches of capital requirements and their consequences.
- BC97 Some respondents to ED 7 did not agree that breaches of externally imposed capital requirements should be disclosed. They argued that disclosure about breaches of externally imposed capital requirements and the associated regulatory measures subsequently imposed could be disproportionately damaging to entities. The Board was not persuaded by these arguments because it believes that such concerns indicate that information about breaches of externally imposed capital requirements may often be material by its nature. The *Framework* states that 'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.' Similarly, the Board decided not to provide an exemption for temporary non-compliance with regulatory requirements during the year. Information that an entity is sufficiently close to its limits to breach them, even on a temporary basis, is useful for users.

Internal capital targets

- BC98 The Board proposed in ED 7 that the requirement to disclose information about breaches of capital requirements should apply equally to breaches of internally imposed requirements, because it believed the information is also useful to a user of the financial statements.
- BC99 However, this proposal was criticised by respondents to ED 7 for the following reasons:
- (a) The information is subjective and, thus, not comparable between entities. In particular, different entities will set internal targets for different reasons, so a breach of a requirement might signify different things for different entities. In contrast, a breach of an external requirement has similar implications for all entities required to comply with similar requirements.
 - (b) Capital targets are not more important than other internally set financial targets, and to require disclosure only of capital targets would provide users with incomplete, and perhaps misleading, information.

- (c) Internal targets are estimates that are subject to change by the entity. It is not appropriate to require the entity's performance against this benchmark to be disclosed.
- (d) An internally set capital target can be manipulated by management. The disclosure requirement could cause management to set the target so that it would always be achieved, providing little useful information to users and potentially reducing the effectiveness of the entity's capital management.

BC100 As a result, the Board decided not to require disclosure of the capital targets set by management, whether the entity has complied with those targets, or the consequences of any non-compliance. However, the Board confirmed its view that when an entity has policies and processes for managing capital, qualitative disclosures about these policies and processes are useful. The Board also concluded that these disclosures, together with disclosure of the components of equity and their changes during the year (required by paragraphs 106–110), would give sufficient information about entities that are not regulated or subject to externally imposed capital requirements.

Puttable financial instruments and obligations arising on liquidation

BC100A The Board decided to require disclosure of information about puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation that are reclassified in accordance with paragraphs 16E and 16F of IAS 32. This is because the Board concluded that this disclosure allows users of financial statements to understand the effects of any reclassifications.

BC100B The Board also concluded that entities with puttable financial instruments classified as equity should be required to disclose additional information to allow users to assess any effect on the entity's liquidity arising from the ability of the holder to put the instruments to the issuer. Financial instruments classified as equity usually do not include any obligation for the entity to deliver a financial asset to another party. Therefore, the Board concluded that additional disclosures are needed in these circumstances. In particular, the Board concluded that entities should disclose the expected cash outflow on redemption or repurchase of those financial instruments that are classified as equity and information about how that amount was determined. That information allows liquidity risk associated with the put obligation and future cash flows to be evaluated.

Presentation of measures per share

BC101 The exposure draft of 2006 did not propose to change the requirements of IAS 33 *Earnings per Share* on the presentation of basic and diluted earnings per share. A majority of respondents agreed with this decision. In their opinion, earnings per share should be the only measure per share permitted or required in the statement of comprehensive income and changing those requirements was beyond the scope of this stage of the financial statement presentation project.

BC102 However, some respondents would like to see alternative measures per share whenever earnings per share is not viewed as the most relevant measure for financial analysts (ie credit rating agencies that focus on other measures). A few respondents proposed that an entity should also display an amount per share for total comprehensive income, because this was considered a useful measure. The Board did not support including alternative measures per share in the financial statements, until totals and subtotals, and principles for aggregating and disaggregating items, are addressed and discussed as part of the next stage of the financial statement presentation project.

- BC103 Some respondents also interpreted the current provisions in IAS 33 as allowing de facto a display of alternative measures in the income statement. In its deliberations, the Board was clear that paragraph 73 of IAS 33 did not leave room for confusion. However, it decided that the wording in paragraph 73 could be improved to clarify that alternative measures should be shown 'only in the notes'. This will be done when IAS 33 is revisited or as part of the annual improvements process.
- BC104 One respondent commented that the use of the word 'earnings' was inappropriate in the light of changes proposed in the exposure draft and that the measure should be denominated 'profit or loss per share', instead. The Board considered that this particular change in terminology was beyond the scope of IAS 1.

Transition and effective date

- BC105 The Board is committed to maintaining a 'stable platform' of substantially unchanged standards for annual periods beginning between 1 January 2006 and 31 December 2008. In addition, some preparers will need time to make the system changes necessary to comply with the revisions to IAS 1. Therefore, the Board decided that the effective date of IAS 1 should be annual periods beginning on or after 1 January 2009, with earlier application permitted.
- BC105A The exposure draft *Presentation of Items of Other Comprehensive Income* published in May 2010 proposed changes to presentation of items of OCI. The Board finalised these changes in June 2011 and decided that the effective dates for these changes should be for annual periods beginning on or after 1 July 2012, with earlier application permitted. The Board did not think that a long transition period was needed as the changes to presentation are small and the presentation required by the amendments is already allowed under IAS 1.
- BC105B The Board had consulted on the effective date and transition requirements for this amendment in its *Request for Views on Effective Dates and Transition Requirements* in October 2010 and the responses to that document did not give the Board any reason to reconsider the effective date and the transition requirements.

Disclosure Initiative (Amendments to IAS 1)

- BC105C The Board decided that *Disclosure Initiative* (Amendments to IAS 1) should be applied for annual periods beginning on or after 1 January 2016 with early application permitted.
- BC105D The Board noted that these amendments clarify existing requirements in IAS 1. They provide additional guidance to assist entities to apply judgement when meeting the presentation and disclosure requirements in IFRS. These amendments do not affect recognition and measurement. They should not result in the reassessment of the judgements about presentation and disclosure made in periods prior to the application of these amendments.
- BC105E Paragraph 38 of IAS 1 requires an entity to present comparative information for all amounts reported in the current period financial statements and for narrative or descriptive information 'if it is relevant to understanding the current period's financial statements'. If an entity alters the order of the notes or the information presented or disclosed compared to the previous year, it also adjusts the comparative information to align with the current period presentation and disclosure. For that reason, IAS 1 already provides relief from having to disclose comparative information that is not considered relevant in the current period and requires comparative information for new amounts presented or disclosed in the current period.

BC105F The March 2014 Exposure Draft proposed that if an entity applies these amendments early that it should disclose that fact. However, the Board removed this requirement and stated in the transition provisions that an entity need not disclose the fact that it has applied these amendments (regardless of whether the amendments have been applied for annual periods beginning on or after 1 January 2016 or if they have been applied early). This is because the Board considers that these amendments are clarifying amendments that do not directly affect an entity's accounting policies or accounting estimates. Similarly, an entity does not need to disclose the information required by paragraphs 28–30 of IAS 8 in relation to these amendments. The Board noted that if an entity decides to change its accounting policies as a result of applying these amendments then it would be required to follow the existing requirements in IAS 8 in relation to those accounting policy changes.

Differences from SFAS 130

BC106 In developing IAS 1, the Board identified the following differences from SFAS 130:

- (a) **Reporting and display of comprehensive income** Paragraph 22 of SFAS 130 permits a choice of displaying comprehensive income and its components, in one or two statements of financial performance or in a statement of changes in equity. IAS 1 (as revised in 2007) does not permit display in a statement of changes in equity.
- (b) **Reporting other comprehensive income in the equity section of a statement of financial position** Paragraph 26 of SFAS 130 specifically states that the *total of other comprehensive income* is reported separately from retained earnings and additional paid-in capital in a statement of financial position at the end of the period. A descriptive title such as *accumulated other comprehensive income* is used for that component of equity. An entity discloses accumulated balances for each classification in that separate component of equity in a statement of financial position, in a statement of changes in equity, or in notes to the financial statements. IAS 1 (as revised in 2007) does not specifically require the display of a total of accumulated other comprehensive income in the statement of financial position.
- (c) **Display of the share of other comprehensive income items of associates and joint ventures accounted for using the equity method** Paragraph 82 of IAS 1 (as revised in 2007) requires the display in the statement of comprehensive income of the investor's share of the investee's other comprehensive income. Paragraph 122 of SFAS 130 does not specify how that information should be displayed. An investor is permitted to combine its proportionate share of other comprehensive income amounts with its own other comprehensive income items and display the aggregate of those amounts in an income statement type format or in a statement of changes in equity.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with the revised IAS 1. Amended paragraphs are shown with the new text underlined and deleted text struck through.

The amendments contained in this appendix when this Standard was revised in 2007 have been incorporated into the relevant pronouncements.

Dissenting opinions

Dissent of Mary E Barth, Anthony T Cope, Robert P Garnett and James J Leisenring from IAS 1 (as revised in September 2007)

- DO1 Professor Barth and Messrs Cope, Garnett and Leisenring voted against the issue of IAS 1 *Presentation of Financial Statements* in 2007. The reasons for their dissent are set out below.
- DO2 Those Board members agree with the requirement to report all items of income and expense separately from changes in net assets that arise from transactions with owners in their capacity as owners. Making that distinction clearly is a significant improvement in financial reporting.
- DO3 However, they believe that the decision to permit entities to divide the statement of comprehensive income into two separate statements is both conceptually unsound and unwise.
- DO4 As noted in paragraph BC51, the *Framework*^{*} does not define profit or loss, or net income. It also does not indicate what criteria should be used to distinguish between those items of recognised income and expense that should be included in profit or loss and those items that should not. In some cases, it is even possible for identical transactions to be reported inside or outside profit or loss. Indeed, in that same paragraph, the Board acknowledges these facts, and indicates that it had a preference for reporting all items of income and expense in a single statement, believing that a single statement is the conceptually correct approach. Those Board members believe that some items of income and expense that will potentially bypass the statement of profit and loss can be as significant to the assessment of an entity's performance as items that will be included. Until a conceptual distinction can be developed to determine whether any items should be reported in profit or loss or elsewhere, financial statements will lack neutrality and comparability unless all items are reported in a single statement. In such a statement, profit or loss can be shown as a subtotal, reflecting current conventions.
- DO5 In the light of those considerations, it is puzzling that most respondents to the exposure draft that proposed these amendments favoured permitting a two-statement approach, reasoning that it 'distinguishes between profit and loss and total comprehensive income' (paragraph BC50). Distinguishing between those items reported in profit or loss and those reported elsewhere is accomplished by the requirement for relevant subtotals to be included in a statement of comprehensive income. Respondents also stated that a two-statement approach gives primacy to the 'income statement'; that conflicts with the Board's requirement in paragraph 11 of IAS 1 to give equal prominence to all financial statements within a set of financial statements.
- DO6 Those Board members also believe that the amendments are flawed by offering entities a choice of presentation methods. The Board has expressed a desire to reduce alternatives in IFRSs. The *Preface to International Financial Reporting Standards*, in paragraph 13[†], states: 'the IASB intends not to permit choices in accounting treatment ... and will continue to reconsider ... those transactions and events for which IASs permit a choice of accounting treatment, with the objective of reducing the number of those choices.' The *Preface* extends this objective to both accounting and reporting. The same paragraph states: 'The IASB's objective is to require like transactions and events to be accounted for *and reported* in a like way and unlike transactions and events to be accounted for *and reported* differently' (emphasis added). By permitting a choice in this instance, the IASB has abandoned that principle.

* The reference to the *Framework* is to IASB's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

† Paragraph 13, slightly amended, is now paragraph 12 of the *Preface*, as amended at September 2010.

- DO7 Finally, the four Board members believe that allowing a choice of presentation at this time will ingrain practice, and make achievement of the conceptually correct presentation more difficult as the long-term project on financial statement presentation proceeds.

Dissent of Paul Pacter from *Presentation of Items of Other Comprehensive Income* (Amendments to IAS 1)

- DO1 Mr Pacter voted against issuing the amendments to IAS 1 *Presentation of Financial Statements* set out in *Presentation of Items of Other Comprehensive Income* in June 2011. Mr Pacter believes that the Board has missed a golden opportunity to align the performance statement with the Board's *Conceptual Framework* and, thereby, improve information for users of IFRS financial statements.
- DO2 Mr Pacter believes that ideally this project should have provided guidance, to the Board and to those who use IFRSs, on which items of income and expense (if any) should be presented as items of other comprehensive income (OCI) and which of those (if any) should subsequently be recycled through profit or loss. Mr Pacter acknowledges and accepts that this project has a more short-term goal – 'to improve the consistency and clarity of the presentation of items of OCI'. He believes that this project fails to deliver on that objective, for the following reasons:
- (a) Consistency is not achieved because the standard allows choice between presenting performance in a single performance statement or two performance statements. Users of financial statements—and the Board itself—have often said that accounting options are not helpful for understandability and comparability of financial statements.
 - (b) Clarity is not achieved because allowing two performance statements is inconsistent with the *Conceptual Framework*. The *Conceptual Framework* defines two types of items that measure an entity's performance—income and expenses. Mr Pacter believes that all items of income and expense should be presented in a single performance statement with appropriate subtotals (including profit or loss, if that can be defined) and supporting disclosures. This is consistent with reporting all assets and liabilities in a single statement of financial position, rather than multiple statements. Unfortunately, neither IAS 1 nor any other IFRS addresses criteria for which items are presented in OCI. And the recent history of which items are presented in OCI suggests that the decisions are based more on expediency than conceptual merit. In Mr Pacter's judgement, that is all the more reason to have all items of income and expense reported in a single performance statement.
- DO3 Mr Pacter believes that the Board should breathe new life into its former project on performance reporting as a matter of urgency.

Guidance on implementing IAS 1 *Presentation of Financial Statements*

This guidance accompanies, but is not part of, IAS 1.

Illustrative financial statement structure

- IG1 IAS 1 sets out the components of financial statements and minimum requirements for disclosure in the statements of financial position, profit or loss and other comprehensive income and changes in equity. It also describes further items that may be presented either in the relevant financial statement or in the notes. This guidance provides simple examples of ways in which the requirements of IAS 1 for the presentation of the statements of financial position, profit or loss and other comprehensive income and changes in equity might be met. An entity should change the order of presentation, the titles of the statements and the descriptions used for line items when necessary to suit its particular circumstances.
- IG2 The guidance is in ~~two~~ three sections. Paragraphs IG3–IG6 provide examples of the presentation of financial statements. Paragraphs IG7–IG9 ~~have been deleted. provide an example of the determination of reclassification adjustments for available-for-sale financial assets in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.~~ Paragraphs IG10 and IG11 provide examples of capital disclosures.
- IG3 The illustrative statement of financial position shows one way in which an entity may present a statement of financial position distinguishing between current and non-current items. Other formats may be equally appropriate, provided the distinction is clear.
- IG4 The illustrations use the term ‘comprehensive income’ to label the total of all items of profit or loss and other comprehensive income. The illustrations use the term ‘other comprehensive income’ to label income and expenses that are included in comprehensive income but excluded from profit or loss. IAS 1 does not require an entity to use those terms in its financial statements.
- IG5 Two statements of profit or loss and other comprehensive income are provided, to illustrate the alternative presentations of income and expenses in a single statement or in two statements. The statement of profit or loss and other comprehensive income illustrates the classification of income and expenses within profit or loss by function. The separate statement (in this example, ‘the statement of profit or loss’) illustrates the classification of income and expenses within profit by nature.
- IG5A Two sets of examples of statements of profit or loss and other comprehensive income are shown. One shows the presentation while IAS 39 *Financial Instruments: Recognition and Measurement* remains effective and is applied; the other shows presentation when IFRS 9 *Financial Instruments* is applied.
- IG6 The examples are not intended to illustrate all aspects of IFRSs, nor do they constitute a complete set of financial statements, which would also include a statement of cash flows, disclosures about significant accounting policies and other explanatory information.

Part I: Illustrative presentation of financial statements**XYZ Group – Statement of financial position as at 31 December 20X7****(in thousands of currency units)**

	31 Dec 20X7	31 Dec 20X6
ASSETS		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	142,500	156,000
~~Available-for-sale financial assets~~		
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200

continued...

*...continued***XYZ Group – Statement of financial position as at 31 December 20X7****(in thousands of currency units)**

	31 Dec 20X7	31 Dec 20X6
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interests	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	177,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)

(in thousands of currency units)

	<u>20X7</u>	<u>20X6</u>
<u>Revenue</u>	390,000	355,000
<u>Cost of sales</u>	<u>(245,000)</u>	<u>(230,000)</u>
<u>Gross profit</u>	145,000	125,000
<u>Other income</u>	20,667	11,300
<u>Distribution costs</u>	(9,000)	(8,700)
<u>Administrative expenses</u>	(20,000)	(21,000)
<u>Other expenses</u>	(2,100)	(1,200)
<u>Finance costs</u>	(8,000)	(7,500)
<u>Share of profit of associates^(a)</u>	<u>35,100</u>	<u>30,100</u>
<u>Profit before tax</u>	161,667	128,000
<u>Income tax expense</u>	<u>(40,417)</u>	<u>(32,000)</u>
<u>Profit for the year from continuing operations</u>	121,250	96,000
<u>Loss for the year from discontinued operations</u>	<u>=</u>	<u>(30,500)</u>
<u>PROFIT FOR THE YEAR</u>	121,250	65,500
<u>Other comprehensive income:</u>		
<u>Items that will not be reclassified to profit or loss:</u>		
<u>Gains on property revaluation</u>	933	3,367
<u>Remeasurements of defined benefit pension plans</u>	(667)	1,333
<u>Share of other comprehensive income of associates^(b)</u>	400	(700)
<u>Income tax relating to items that will not be reclassified^(c)</u>	<u>(166)</u>	<u>(1,000)</u>
	500	3,000
<u>Items that may be reclassified subsequently to profit or loss:</u>		
<u>Exchange differences on translating foreign operations^(d)</u>	5,334	10,667
<u>Available-for-sale financial assets^(d)</u>	(24,000)	26,667
<u>Cash flow hedges^(d)</u>	(667)	(4,000)
<u>Income tax relating to items that may be reclassified^(c)</u>	4,833	(8,334)
	<u>(14,500)</u>	<u>25,000</u>
<u>Other comprehensive income for the year, net of tax</u>	(14,000)	28,000
<u>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</u>	<u>107,250</u>	<u>93,500</u>

continued...

...continued

Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied**XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7****(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)****(in thousands of currency units)**

	<u>20X7</u>	<u>20X6</u>
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	<u>121,250</u>	<u>65,500</u>
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	<u>107,250</u>	<u>93,500</u>
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:**Items that will not be reclassified to profit or loss:**

Gains on property revaluation	600	2,700
Remeasurements of defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
	<u>500</u>	<u>3,000</u>

Items that may be reclassified subsequently to profit or loss:

Exchange differences on translating foreign operations	4,000	8,000
Investments in equity instruments	(18,000)	20,000
Cash flow hedges	(500)	(3,000)
	<u>(14,500)</u>	<u>25,000</u>

Other comprehensive income for the year, net of tax^(c)	<u><u>(14,000)</u></u>	<u><u>28,000</u></u>

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

continued...

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- (b) This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.
- (c) The income tax relating to each item of other comprehensive income is disclosed in the notes.
- (d) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7		
(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)		
(in thousands of currency units)		
	<u>20X7</u>	<u>20X6</u>
<u>Revenue</u>	<u>390,000</u>	<u>355,000</u>
<u>Other income</u>	<u>20,667</u>	<u>11,300</u>
<u>Changes in inventories of finished goods and work in progress</u>	<u>(115,100)</u>	<u>(107,900)</u>
<u>Work performed by the entity and capitalised</u>	<u>16,000</u>	<u>15,000</u>
<u>Raw material and consumables used</u>	<u>(96,000)</u>	<u>(92,000)</u>
<u>Employee benefits expense</u>	<u>(45,000)</u>	<u>(43,000)</u>
<u>Depreciation and amortisation expense</u>	<u>(19,000)</u>	<u>(17,000)</u>
<u>Impairment of property, plant and equipment</u>	<u>(4,000)</u>	<u>=</u>
<u>Other expenses</u>	<u>(6,000)</u>	<u>(5,500)</u>
<u>Finance costs</u>	<u>(15,000)</u>	<u>(18,000)</u>
<u>Share of profit of associates^(a)</u>	<u>35,100</u>	<u>30,100</u>
<u>Profit before tax</u>	<u>161,667</u>	<u>128,000</u>
<u>Income tax expense</u>	<u>(40,417)</u>	<u>(32,000)</u>
<u>Profit for the year from continuing operations</u>	<u>121,250</u>	<u>96,000</u>
<u>Loss for the year from discontinued operations</u>	<u>=</u>	<u>(30,500)</u>
<u>PROFIT FOR THE YEAR</u>	<u>121,250</u>	<u>65,500</u>
<u>Profit attributable to:</u>		
<u>Owners of the parent</u>	<u>97,000</u>	<u>52,400</u>
<u>Non-controlling interests</u>	<u>24,250</u>	<u>13,100</u>
	<u>121,250</u>	<u>65,500</u>
<u>Earnings per share (in currency units):</u>		
<u>Basic and diluted</u>	<u>0.46</u>	<u>0.30</u>
(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.		

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7**(illustrating the presentation of profit or loss and other comprehensive income in two statements)****(in thousands of currency units)**

	<u>20X7</u>	<u>20X6</u>
<u>Profit for the year</u>	<u>121,250</u>	<u>65,500</u>
<u>Other comprehensive income:</u>		
<u>Items that will not be reclassified to profit or loss:</u>		
<u>Gains on property revaluation</u>	<u>933</u>	<u>3,367</u>
<u>Remeasurements of defined benefit pension plans</u>	<u>(667)</u>	<u>1,333</u>
<u>Share of other comprehensive income of associates^(a)</u>	<u>400</u>	<u>(700)</u>
<u>Income tax relating to items that will not be reclassified^(b)</u>	<u>(166)</u>	<u>(1,000)</u>
	<u>500</u>	<u>3,000</u>
<u>Items that may be reclassified subsequently to profit or loss:</u>		
<u>Exchange differences on translating foreign operations</u>	<u>5,334</u>	<u>10,667</u>
<u>Investment in equity instruments</u>	<u>(24,000)</u>	<u>26,667</u>
<u>Cash flow hedges</u>	<u>(667)</u>	<u>(4,000)</u>
<u>Income tax relating to items that may be reclassified^(b)</u>	<u>4,833</u>	<u>(8,334)</u>
	<u>(14,500)</u>	<u>25,000</u>
<u>Other comprehensive income for the year, net of tax</u>	<u>(14,000)</u>	<u>28,000</u>
<u>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</u>	<u>107,250</u>	<u>93,500</u>
<u>Total comprehensive income attributable to:</u>		
<u>Owners of the parent</u>	<u>85,800</u>	<u>74,800</u>
<u>Non-controlling interests</u>	<u>21,450</u>	<u>18,700</u>
	<u>107,250</u>	<u>93,500</u>

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(a) This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.

(b) The income tax relating to each item of other comprehensive income is disclosed in the notes.

Examples of statement of profit or loss and other comprehensive income when IFRS 9 Financial Instruments is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Cost of sales	<u>(245,000)</u>	<u>(230,000)</u>
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates ^(a)	<u>35,100</u>	<u>30,100</u>
Profit before tax	161,667	128,000
Income tax expense	<u>(40,417)</u>	<u>(32,000)</u>
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	<u>–</u>	<u>(30,500)</u>
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
<u>Investments in equity instruments</u>	<u>(24,000)</u>	<u>26,667</u>
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates ^(b)	400	(700)
Income tax relating to items that will not be reclassified ^(c)	<u>5,834</u> ~~(166)~~	<u>(7,667)</u> ~~(1,000)~~
	<u>(17,500)</u> <u>500</u>	<u>23,000</u>
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations ^(d)	5,334	10,667
~~Available for sale financial assets^(e)~~	~~(24,000)~~	~~26,667~~
Cash flow hedges ^(d)	(667)	(4,000)
Income tax relating to items that may be reclassified ^(c)	<u>(1,167)</u> <u>4,833</u>	<u>(1,667)</u> <u>8,334</u>
	<u>3,500</u> <u>(14,500)</u>	<u>25,000</u>
Other comprehensive income for the year, net of tax	<u>(14,000)</u>	<u>28,000</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>107,250</u>	<u>93,500</u>

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Examples of statement of profit or loss and other comprehensive income when IFRS 9 Financial Instruments is applied**XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7****(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)****(in thousands of currency units)**

	<u>20X7</u>	<u>20X6</u>
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	<u>121,250</u>	<u>65,500</u>
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	<u>107,250</u>	<u>93,500</u>
Earnings per share (in currency units):		
Basic and diluted	<u>0.46</u>	<u>0.30</u>

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:	20X7	20X6
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
<u>Investments in equity instruments</u>	<u>(18,000)</u>	<u>20,000</u>
Remeasurements of defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
	<u>(17,500)</u>	<u>23,000</u>
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
~~Available-for-sale financial assets~~	~~(18,000)~~	~~20,000~~
Cash flow hedges	(500)	(3,000)
	<u>3,500</u> ~~(14,500)~~	<u>25,000</u>
Other comprehensive income for the year, net of tax^(c)	<u>(14,000)</u>	<u>28,000</u>

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

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- (b) This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.
- (c) The income tax relating to each item of other comprehensive income is disclosed in the notes.
- (d) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates ^(a)	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	<u>121,250</u>	<u>65,500</u>
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	<u>121,250</u>	<u>65,500</u>
Earnings per share (in currency units):		
Basic and diluted	<u>0.46</u>	<u>0.30</u>

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7**(illustrating the presentation of profit or loss and other comprehensive income in two statements)****(in thousands of currency units)**

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
<u>Investments in equity instruments</u>	<u>(24,000)</u>	<u>26,667</u>
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates ^(a)	400	(700)
Income tax relating to items that will not be reclassified ^(b)	<u>5,834</u> ~~(166)~~	<u>(7,667)</u> ~~(1,000)~~
	<u>(17,500)</u> ~~500~~	<u>23,000</u>
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
~~Available for sale financial assets~~	~~(24,000)~~	~~26,667~~
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified ^(b)	<u>(1,167)</u> ~~4,833~~	<u>(1,667)</u> ~~(8,334)~~
	<u>3,500</u> ~~(14,500)~~	<u>25,000</u>
Other comprehensive income for the year, net of tax	<u>(14,000)</u>	<u>28,000</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>107,250</u>	<u>93,500</u>
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	<u>21,450</u>	<u>18,700</u>
	<u>107,250</u>	<u>93,500</u>

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(a) This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.

(b) The income tax relating to each item of other comprehensive income is disclosed in the notes.

XYZ Group**Disclosure of components of other comprehensive income^(a)****Notes****Year ended 31 December 20X7****(in thousands of currency units)**

		20X7		20X6
Other comprehensive income:				
Exchange differences on translating foreign operations ^(b)		5,334		10,667
<u>Investments in equity instruments</u>		<u>(24,000)</u>		<u>26,667</u>
~~Available-for-sale financial assets:~~				
~~Gains arising during the year~~	~~1,333~~		~~30,667~~	
~~Less: Reclassification adjustments for gains included in profit or loss~~	~~(25,333)~~	~~(24,000)~~	~~(4,000)~~	~~26,667~~
 ~~Cash flow hedges:~~				
~~Cash flow hedges:~~				
~~Gains (losses) arising during the year~~	~~(4,667)~~		~~(4,000)~~	
~~Less: Reclassification adjustments for gains (losses) included in profit or loss~~	~~3,333~~	~~(667)~~	~~—~~	~~(4,000)~~
~~Less: Adjustments for amounts transferred to initial carrying amount of hedged items~~	~~667~~	~~(667)~~	~~—~~	~~(4,000)~~

continued...

*...continued***XYZ Group****Disclosure of components of other comprehensive income****Notes****Year ended 31 December 20X7****(in thousands of currency units)**

	20X7	20X6
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	<u>400</u>	<u>(700)</u>
Other comprehensive income	(18,667)	37,334
Income tax relating to components of other comprehensive income ^(c)	<u>4,667</u>	<u>(9,334)</u>
Other comprehensive income for the year	<u>(14,000)</u>	<u>28,000</u>

- (a) When an entity chooses an aggregated presentation in the statement of comprehensive income, the amounts for reclassification adjustments and current year gain or loss are presented in the notes.
- (b) There was no disposal of a foreign operation. Therefore, there is no reclassification adjustment for the years presented.
- (c) The income tax relating to each component of other comprehensive income is disclosed in the notes.

XYZ Group**Disclosure of tax effects relating to each component of other comprehensive income****Notes****Year ended 31 December 20X7**

(in thousands of currency units)

	Before-tax amount	20X7 Tax (expense) benefit	Net-of-tax amount	Before-tax amount	20X6 Tax (expense) benefit	Net-of-tax amount
Exchange differences on translating foreign operations	5,334	(1,334)	4,000	10,667	(2,667)	8,000
<u>Investments in equity instruments</u> <u>Available for sale financial assets</u>	(24,000)	6,000	(18,000)	26,667	(6,667)	20,000
Cash flow hedges	(667)	167	(500)	(4,000)	1,000	(3,000)
Gains on property revaluation	933	(333)	600	3,367	(667)	2,700
Remeasurements of defined benefit pension plans	(667)	167	(500)	1,333	(333)	1,000
Share of other comprehensive income of associates	<u>400</u>	<u>–</u>	<u>400</u>	<u>(700)</u>	<u>–</u>	<u>(700)</u>
Other comprehensive income	<u>(18,667)</u>	<u>4,667</u>	<u>(14,000)</u>	<u>37,334</u>	<u>(9,334)</u>	<u>28,000</u>

XYZ Group – Statement of changes in equity for the year ended 31 December 20X7
(in thousands of currency units)

	Share capital	Retained earnings	Translation of foreign operations	Investments in equity instruments	Cash flow hedges	Revaluation surplus	Total	Non-controlling interests	Total equity
Balance at 1 January 20X6	600,000	118,100	(4,000)	1,600	2,000	–	717,700	29,800	747,500
Changes in accounting policy	–	400	–	–	–	–	400	100	500
Restated balance	600,000	118,500	(4,000)	1,600	2,000	–	718,100	29,900	748,000
Changes in equity for 20X6									
Dividends	–	(10,000)	–	–	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year ^(a)	–	53,200	6,400	16,000	(2,400)	1,600	74,800	18,700	93,500
Balance at 31 December 20X6	600,000	161,700	2,400	17,600	(400)	1,600	782,900	48,600	831,500
Changes in equity for 20X7									
Issue of share capital	50,000	–	–	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year ^(b)	–	96,600	3,200	(14,400)	(400)	800	85,800	21,450	107,250
Transfer to retained earnings	–	200	–	–	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	5,600	3,200	(800)	2,200	903,700	70,050	973,750

continued...

...continued

- (a) The amount included in retained earnings for 20X6 of 53,200 represents profit attributable to owners of the parent of 52,400 plus remeasurements of defined benefit pension plans of 800 (1,333, less tax 333, less non-controlling interests 200).

The amount included in the translation, ~~investments in equity instruments available for sale~~ and cash flow hedge reserves represent other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to ~~investments in equity instruments available for sale financial assets~~ for 20X6 of 16,000 is 26,667, less tax 6,667, less non-controlling interests 4,000.

The amount included in the revaluation surplus of 1,600 represents the share of other comprehensive income of associates of (700) plus gains on property revaluation of 2,300 (3,367, less tax 667, less non-controlling interests 400). Other comprehensive income of associates relates solely to gains or losses on property revaluation.

- (b) The amount included in retained earnings for 20X7 of 96,600 represents profit attributable to owners of the parent of 97,000 plus remeasurements of defined benefit pension plans of 400 (667, less tax 167, less non-controlling interests 100).

The amount included in the translation, ~~investments in equity instruments available for sale~~ and cash flow hedge reserves represents other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to the translation of foreign operations for 20X7 of 3,200 is 5,334, less tax 1,334, less non-controlling interests 800.

The amount included in the revaluation surplus of 800 represents the share of other comprehensive income of associates of 400 plus gains on property revaluation of 400 (933, less tax 333, less non-controlling interests 200). Other comprehensive income of associates relates solely to gains or losses on property revaluation.

Part II: Illustrative example of the determination of reclassification adjustments

~~IG7:~~

~~IG9 [Deleted] The Standard requires an entity to disclose reclassification adjustments relating to each component of other comprehensive income.~~

~~IG8 This guidance provides an illustration of the calculation of reclassification adjustments for available for sale financial assets recognised in accordance with IAS 39.~~

~~IG9 On 31 December 20X5, XYZ Group purchased 1,000 shares (equity instruments) at 10 currency units (CU) per share, classified as available for sale. The fair value of the instruments at 31 December 20X6 was CU12; at 31 December 20X7 the fair value had increased to CU15. All of the instruments were sold on 31 December 20X7; no dividends were declared on those instruments during the time that they were held by XYZ Group. The applicable tax rate in accordance with IAS 12 *Income Taxes* is 30 per cent.~~

Calculation of gains

(in currency units)

	Before tax	Income tax	Net of tax
Gains recognised in other comprehensive income:			
Year ended 31 December 20X6	2,000	(600)	1,400
Year ended 31 December 20X7	<u>3,000</u>	<u>(900)</u>	<u>2,100</u>
Total gain	<u><u>5,000</u></u>	<u><u>(1,500)</u></u>	<u><u>3,500</u></u>

Amounts reported in profit or loss and other comprehensive income for the years ended 31 December 20X6 and 31 December 20X7

	20X7	20X6
Profit or loss:		
Gain on sale of instruments	5,000	
Income tax expense	<u>(1,500)</u>	
Net gain recognised in profit or loss	<u>3,500</u>	
Other comprehensive income:		
Gain arising during the year, net of tax	2,100	1,400
Reclassification adjustment, net of tax	<u>(3,500)</u>	<u>—</u>
Net gain (loss) recognised in other comprehensive income	<u>(1,400)</u>	<u>1,400</u>
	<u>2,100</u>	<u>1,400</u>

Alternatively, components of other comprehensive income may be shown gross of tax with a separate line item for tax effects:

	20X7	20X6
Profit or loss:		
Gain on sale of instruments	5,000	
Income tax expense	<u>(1,500)</u>	
Net gain recognised in profit or loss	<u>3,500</u>	
Other comprehensive income:		
Gain arising during the year	3,000	2,000
Reclassification adjustment	<u>(5,000)</u>	<u>—</u>
Income tax relating to other comprehensive income	<u>600</u>	<u>(600)</u>
Net gain (loss) recognised in other comprehensive income	<u>(1,400)</u>	<u>1,400</u>
	<u>2,100</u>	<u>1,400</u>

Part III: Illustrative examples of capital disclosures (paragraphs 134–136)

An entity that is not a regulated financial institution

- IG10 The following example illustrates the application of paragraphs 134 and 135 for an entity that is not a financial institution and is not subject to an externally imposed capital requirement. In this example, the entity monitors capital using a debt-to-adjusted capital ratio. Other entities may use different methods to monitor capital. The example is also relatively simple. An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of paragraphs 134 and 135. In determining the form and content of the disclosure to satisfy those requirements, an entity also considers the disclosure requirements set out in paragraphs 44A–44E of IAS 7 *Statement of Cash Flows*.

Facts

Group A manufactures and sells cars. Group A includes a finance subsidiary that provides finance to customers, primarily in the form of leases. Group A is not subject to any externally imposed capital requirements.

Example disclosure

The Group's objectives when managing capital are:

- to safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders, and
- to provide an adequate return to shareholders by pricing products and services commensurately with the level of risk.

The Group sets the amount of capital in proportion to risk. The Group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares, or sell assets to reduce debt.

Consistently with others in the industry, the Group monitors capital on the basis of the debt-to-adjusted capital ratio. This ratio is calculated as net debt ÷ adjusted capital. Net debt is calculated as total debt (as shown in the statement of financial position) less cash and cash equivalents. Adjusted capital comprises all components of equity (ie share capital, share premium, non-controlling interests, retained earnings, and revaluation surplus) other than amounts accumulated in equity relating to cash flow hedges, and includes some forms of subordinated debt.

continued...

...continued

During 20X4, the Group's strategy, which was unchanged from 20X3, was to maintain the debt-to-adjusted capital ratio at the lower end of the range 6:1 to 7:1, in order to secure access to finance at a reasonable cost by maintaining a BB credit rating. The debt-to-adjusted capital ratios at 31 December 20X4 and at 31 December 20X3 were as follows:

	31 Dec 20X4	31 Dec 20X3
	CU million	CU million
Total debt	1,000	1,100
Less: cash and cash equivalents	<u>(90)</u>	<u>(150)</u>
Net debt	<u>910</u>	<u>950</u>
Total equity	110	105
Add: subordinated debt instruments	38	38
Less: amounts accumulated in equity relating to cash flow hedges	<u>(10)</u>	<u>(5)</u>
Adjusted capital	<u>138</u>	<u>138</u>
Debt-to-adjusted capital ratio	6.6	6.9

The decrease in the debt-to-adjusted capital ratio during 20X4 resulted primarily from the reduction in net debt that occurred on the sale of subsidiary Z. As a result of this reduction in net debt, improved profitability and lower levels of managed receivables, the dividend payment was increased to CU2.8 million for 20X4 (from CU2.5 million for 20X3).

An entity that has not complied with externally imposed capital requirements

- IG11 The following example illustrates the application of paragraph 135(e) when an entity has not complied with externally imposed capital requirements during the period. Other disclosures would be provided to comply with the other requirements of paragraphs 134 and 135.

Facts

Entity A provides financial services to its customers and is subject to capital requirements imposed by Regulator B. During the year ended 31 December 20X7, Entity A did not comply with the capital requirements imposed by Regulator B. In its financial statements for the year ended 31 December 20X7, Entity A provides the following disclosure relating to its non-compliance.

Example disclosure

Entity A filed its quarterly regulatory capital return for 30 September 20X7 on 20 October 20X7. At that date, Entity A's regulatory capital was below the capital requirement imposed by Regulator B by CU1 million. As a result, Entity A was required to submit a plan to the regulator indicating how it would increase its regulatory capital to the amount required. Entity A submitted a plan that entailed selling part of its unquoted equities portfolio with a carrying amount of CU11.5 million in the fourth quarter of 20X7. In the fourth quarter of 20X7, Entity A sold its fixed interest investment portfolio for CU12.6 million and met its regulatory capital requirement.

Appendix

Amendments to guidance on other IFRSs

The following amendments to guidance on other IFRSs are necessary in order to ensure consistency with the revised IAS 1. In the amended paragraphs, new text is underlined and deleted text is struck through.

The amendments contained in this appendix when this guidance was issued have been incorporated into the text of the relevant guidance.

Amendments to the guidance on implementing IAS 1 *Disclosure Initiative*

The following sets out amendments required for this Implementation Guidance resulting from amendments to IAS 1 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Guidance and this appendix will be deleted.

The versions of IAS 1 that include examples of statement of profit or loss and other comprehensive income when IFRS 9 *Financial Instruments* is applied are amended. Deleted text is struck through and new text is underlined.

...

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)

...

	20X7	20X6
...		
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates ^(b)	400	(700)
Income tax relating to items that will not be reclassified ^(c)	5,834	(7,667)
	<u>(17,500)</u>	<u>23,000</u>

...

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:

Items that will not be reclassified to profit or loss:

Gains on property revaluation	600	2,700
Investments in equity instruments	(18,000)	20,000
Remeasurements of defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
	<u>(17,500)</u>	<u>23,000</u>

...

~~(a) ...~~

~~(b) — This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.~~

~~(c) — The income tax relating to each item of other comprehensive income is disclosed in the notes.~~

~~(d) ...~~

~~...~~

~~(illustrating the presentation of profit or loss and other comprehensive income in two statements)~~

~~...~~

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates ^(a)	400	(700)
Income tax relating to items that will not be reclassified ^(b)	5,834	(7,667)
	<u>(17,500)</u>	<u>23,000</u>

~~...~~

~~Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.~~

~~(a) — This means the share of associates' other comprehensive income attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required by paragraph 82A(b) to present that amount in a separate line.~~

~~(b) — The income tax relating to each item of other comprehensive income is disclosed in the notes.~~

Table of Concordance

This table shows how the contents of HKAS 1 and HKAS 1 (revised 2007) correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded HKAS 1 paragraph	HKAS 1 (revised 2007) paragraph	Superseded HKAS 1 paragraph	HKAS 1 (revised 2007) paragraph	Superseded HKAS 1 paragraph	HKAS 1 (revised 2007) paragraph
1	1, 3	42, 43	47, 48	101	None
2	2	44–48	49–53	102	111
3	4, 7	49, 50	36, 37	103–107	112–116
4	None	51–67	60–76	108–115	117–124
5	5	68	54	116–124	125–133
6	6	68A	54	124A–124C	134–136
7	9	69–73	55–59	125, 126	137, 138
8	10	74–77	77–80	127	139
9, 10	13, 14	None	81	127A	None
11	7	78	88	127B	None
12	7	79	89	128	140
None	8	80	89	IG1	IG1
None	11, 12	81	82	None	IG2
13–22	15–24	82	83	IG2	IG3
23, 24	25, 26	None	84	None	IG4
25, 26	27, 28	83–85	85–87	IG3, IG4	IG5, IG6
27, 28	45, 46	None	90–96	None	IG7
29–31	29–31	86–94	97–105	None	IG8
32–35	32–35	95	107	None	IG9
36	38	None	108	IG5, IG6	IG10, IG11
None	39	96, 97	106, 107		
37–41	40–44	98	109		

HKAS 2
Revised ~~February 2014~~ September 2018

Effective for annual periods beginning
on or after 1 January 2005

Hong Kong Accounting Standard 2

Inventories



Hong Kong Institute of
Certified Public Accountants
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Hong Kong Accounting Standard 2

Inventories

Objective

- 1 The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

- 2 **This Standard applies to all inventories, except:**
 - (a) ~~[deleted]work in progress arising under construction contracts, including directly related service contracts (see HKAS 11 Construction Contracts);~~
 - (b) **financial instruments (see HKAS 32 *Financial Instruments: Presentation* and HKFRSAS 39 *Financial Instruments: Recognition and Measurement*); and**
 - (c) **biological assets related to agricultural activity and agricultural produce at the point of harvest (see HKAS 41 *Agriculture*).**
- 3 **This Standard does not apply to the measurement of inventories held by:**
 - (a) **producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.**
 - (b) **commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.**
- 4 The inventories referred to in paragraph 3(a) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or minerals have been extracted and sale is assured under a forward contract or a government guarantee, or when an active market exists and there is a negligible risk of failure to sell. These inventories are excluded from only the measurement requirements of this Standard.

- 5 Broker-traders are those who buy or sell commodities for others or on their own account. The inventories referred to in paragraph 3(b) are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this Standard.

Definitions

- 6 **The following terms are used in this Standard with the meanings specified:**

Inventories are assets:

- (a) **held for sale in the ordinary course of business;**
- (b) **in the process of production for such sale; or**
- (c) **in the form of materials or supplies to be consumed in the production process or in the rendering of services.**

Net realisable 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.

*Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13 *Fair Value Measurement*)*

- 7 Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.
- 8 Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. ~~In the case of a service provider, inventories include the costs of the service, as described in paragraph 19, for which the entity has not yet recognised the related revenue (see HKAS 18 *Revenue*). Costs incurred to fulfil a contract with a customer that do not give rise to inventories (or assets within the scope of another Standard) are accounted for in accordance with HKFRS 15 *Revenue from Contracts with Customers*.~~

Measurement of inventories

- 9 **Inventories shall be measured at the lower of cost and net realisable value.**

Cost of inventories

- 10 **The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.**

- 16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
- (a) abnormal amounts of wasted materials, labour or other production costs;
 - (b) storage costs, unless those costs are necessary in the production process before a further production stage;
 - (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - (d) selling costs.
- 17 HKAS 23 *Borrowing Costs* identifies limited circumstances where borrowing costs are included in the cost of inventories.
- 18 An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

Cost of inventories of a service provider

- 19 ~~[Deleted] To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.~~

Cost of agricultural produce harvested from biological assets

- 20 In accordance with HKAS 41 *Agriculture* inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

Techniques for the measurement of cost

- 21 Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.
- 22 The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

Cost formulas

- 23 **The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.**
- 24 Specific identification of cost means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on profit or loss.
- 25 **The cost of inventories, other than those dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.**
- 26 For example, inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.
- 27 The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Net realisable value

- 28 The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.
- 29 Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment. ~~Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item.~~

Disclosure

- 36 **The financial statements shall disclose:**
- (a) **the accounting policies adopted in measuring inventories, including the cost formula used;**
 - (b) **the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;**
 - (c) **the carrying amount of inventories carried at fair value less costs to sell;**
 - (d) **the amount of inventories recognised as an expense during the period;**
 - (e) **the amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 34;**
 - (f) **the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34;**
 - (g) **the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34; and**
 - (h) **the carrying amount of inventories pledged as security for liabilities.**
- 37 Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. ~~The inventories of a service provider may be described as work in progress.~~
- 38 The amount of inventories recognised as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs.
- 39 Some entities adopt a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

Effective date

- 40 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

- 40a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.
- 40A ~~[Deleted]~~~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~
- 40B ~~[Deleted]~~~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~
- 40C HKFRS 13, issued in June 2011, amended the definition of fair value in paragraph 6 and amended paragraph 7. An entity shall apply those amendments when it applies HKFRS 13.
- 40D ~~[Deleted]~~
- 40E HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 2, 8, 29 and 37 and deleted paragraph 19. An entity shall apply those amendments when it applies HKFRS 15.
- 40F HKFRS 9, as issued in September 2014, amended paragraphs 2 and deleted paragraphs 40A, 40B and 40D. An entity shall apply those amendments when it applies HKFRS 9.

Withdrawal of other pronouncements

- 41 This Standard supersedes SSAP 22 *Inventories*, revised in 2001.
- 42 [Not used]

HKAS 8
Revised ~~February 2014~~ September 2018

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 8

Accounting Policies, Changes in Accounting Estimates and Errors



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- (b) would have been available when the financial statements for that prior period were authorised for issue

from other information. For some types of estimates (eg a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

- 53 Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in measuring financial assets previously classified as held to maturity investments in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*, it does not change their basis of measurement for that period if management decided later not to hold them to maturity. In addition, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with HKAS 19 *Employee Benefits*, it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

Effective date

- 54 **An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.**
- 54a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the same effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.
- 54A ~~[Deleted] [This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~
- 54B ~~[Deleted] [This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~
- 54C HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended paragraph 52. An entity shall apply that amendment when it applies HKFRS 13.
- 54D ~~[Deleted]~~
- 54E HKFRS 9 *Financial Instruments*, as issued in September 2014, amended paragraph 53 and deleted paragraphs 54A, 54B and 54D. An entity shall apply those amendments when it applies HKFRS 9.

Withdrawal of other pronouncements

- 55 This Standard supersedes SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, revised in 2001.
- 56 [Not used]

Hong Kong Accounting Standard 10

Events after the Reporting Period



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- (a) the settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. The entity adjusts any previously recognised provision related to this court case in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or recognises a new provision. The entity does not merely disclose a contingent liability because the settlement provides additional evidence that would be considered in accordance with paragraph 16 of HKAS 37.
- (b) the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:
 - (i) the bankruptcy of a customer that occurs after the reporting period usually confirms that ~~a loss existed~~ the customer was credit-impaired at the end of the reporting period ~~on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable; and~~
 - (ii) the sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.
- (c) the determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.
- (d) the determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date (see HKAS 19 *Employee Benefits*).
- (e) the discovery of fraud or errors that show that the financial statements are incorrect.

Non-adjusting events after the reporting period

- 10 An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.**
- 11 An example of a non-adjusting event after the reporting period is a decline in fair value of investments between the end of the reporting period and the date when the financial statements are authorised for issue. The decline in fair value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure under paragraph 21.

- 18 It is important for users to know when the financial statements were authorised for issue, because the financial statements do not reflect events after this date.

Updating disclosure about conditions at the end of the reporting period

- 19 **If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.**
- 20 In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether it should recognise or change a provision under HKAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~, an entity updates its disclosures about the contingent liability in the light of that evidence.

Non-adjusting events after the reporting period

- 21 **If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:**
- (a) **the nature of the event; and**
 - (b) **an estimate of its financial effect, or a statement that such an estimate cannot be made.**
- 22 The following are examples of non-adjusting events after the reporting period that would generally result in disclosure:
- (a) a major business combination after the reporting period (HKFRS 3 *Business Combinations* requires specific disclosures in such cases) or disposing of a major subsidiary;
 - (b) announcing a plan to discontinue an operation;
 - (c) major purchases of assets, classification of assets as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, other disposals of assets, or expropriation of major assets by government;
 - (d) the destruction of a major production plant by a fire after the reporting period;
 - (e) announcing, or commencing the implementation of, a major restructuring (see HKAS 37);
 - (f) major ordinary share transactions and potential ordinary share transactions after the reporting period (HKAS 33 *Earnings per Share* requires an entity to disclose a description of such transactions, other than when such transactions involve capitalisation or bonus issues, share splits or reverse share splits all of which are required to be adjusted under HKAS 33);

- (g) abnormally large changes after the reporting period in asset prices or foreign exchange rates;
- (h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see HKAS 12 *Income Taxes*);
- (i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and
- (j) commencing major litigation arising solely out of events that occurred after the reporting period.

Effective date

23 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

23a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

23A HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended paragraph 11. An entity shall apply that amendment when it applies HKFRS 13.

23B HKFRS 9 *Financial Instruments*, as issued in September 2014, amended paragraph 9. An entity shall apply that amendment when it applies HKFRS 9.

Withdrawal of SSAP 9 (revised 2001)

24 This Standard supersedes SSAP 9 *Events After the Balance Sheet Date* (revised in 2001).

Hong Kong Accounting Standard 11

Construction Contracts

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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Hong Kong Accounting Standard 12

Income Taxes



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Assets carried at fair value

- 20 HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment*, HKAS 38 *Intangible Assets*, ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~ and HKAS 40 *Investment Property* and ~~HKFRS 9 *Financial Instruments*~~). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises. In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. 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. This is true even if:
- (a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or
 - (b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

Goodwill

- 21* Goodwill arising in a business combination is measured as the excess of (a) over (b) below
- (a) the aggregate of:
 - (i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
 - (ii) the amount of any non-controlling interest in the acquiree recognised in accordance with HKFRS 3; and
 - (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - (b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with HKFRS 3.

Many taxation authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, in such jurisdictions, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. In such jurisdictions, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, this Standard does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.

- 21A* Subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognised under paragraph 15(a). For example, if in a business combination an entity recognises goodwill of CU100 that has a tax base of nil, paragraph 15(a) prohibits the entity from recognising the resulting deferred tax liability. If the entity subsequently recognises an impairment loss of CU20 for that goodwill, the amount of the taxable temporary difference relating to the goodwill is reduced from CU100 to CU80, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised under paragraph 15(a).

* __Amendments effective for annual periods beginning on or after 1 July 2009.

- 27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.
- 27A When an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, it considers whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference. If tax law imposes no such restrictions, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences. However, if tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.
- 28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:
- (a) in the same period as the expected reversal of the deductible temporary difference; or
 - (b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.
- In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.
- 29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:
- (a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:
 - (i) compares the deductible temporary differences with future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is sufficient for the entity to deduct the amounts resulting from the reversal of those deductible temporary differences-; and
 - (ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilized-; or
 - (b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.
- 29A The estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it is probable that the entity will achieve this. For example, when an asset is measured at fair value, the entity shall consider whether there is sufficient evidence to conclude that it is probable that the entity will recover the asset for more than its carrying amount. This may be the case, for example, when an entity expects to hold a fixed-rate debt instrument and collect the contractual cash flows.

Recognition of current and deferred tax

- 57 Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

Items recognised in profit or loss

- 58 **Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:**

- (a) **a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A - 65); or**
- (b) **a business combination (other than the acquisition by an investment entity, as defined in HKFRS 10 *Consolidated Financial Statements*, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66 - 68).**

- 59 Most deferred tax liabilities and deferred tax assets arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in profit or loss. Examples are when:

- (a) interest, royalty or dividend revenue is received in arrears and is included in accounting profit ~~on a time-apportionment basis in accordance with HKAS 18 HKFRS 15 *Revenue from Contracts with Customers*, HKAS 39 *Financial Instruments: Recognition and Measurement* or HKFRS 9 *Financial Instruments*, as relevant~~, but is included in taxable profit (tax loss) on a cash basis; and
- (b) costs of intangible assets have been capitalised in accordance with HKAS 38, and are being amortised in profit or loss, but were deducted for tax purposes when they were incurred.

- 60 The carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences. This can result, for example, from:

- (a) a change in tax rates or tax laws;
- (b) a reassessment of the recoverability of deferred tax assets; or
- (c) a change in the expected manner of recovery of an asset.

The resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss (see paragraph 63).

Items recognised outside profit or loss

- 61 [Deleted]

- 61A **Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:**

- (a) **in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).**
- (b) **directly in equity, shall be recognised directly in equity (see paragraph 62A).**

- 93 Paragraph 68 shall be applied prospectively from the effective date of HKFRS 3 (as revised in 2008) to the recognition of deferred tax assets acquired in business combinations.
- 94 Therefore, entities shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the benefits are recognised within the measurement period and result from new information about facts and circumstances that existed at the acquisition date. Other tax benefits recognised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).
- 95 HKFRS 3 (as revised in 2008) amended paragraphs 21 and 67 and added paragraphs 32A and 81(j) and (k). An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 96 [Deleted]
- 97 [Deleted]
- 98 Paragraph 52 was renumbered as 51A, paragraph 10 and the examples following paragraph 51A were amended, and paragraphs 51B and 51C and the following example and paragraphs 51D, 51E and 99 were added by *Deferred Tax: Recovery of Underlying Assets*, issued in December 2010. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.
- 98A HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 2, 15, 18(e), 24, 38, 39, 43–45, 81(f), 87 and 87C. An entity shall apply those amendments when it applies HKFRS 11.
- 98B *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 77 and deleted paragraph 77A. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 98C *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraphs 58 and 68C. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 98D [Deleted]
- 98E ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~ HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 59. An entity shall apply that amendment when it applies HKFRS 15.
- 98F ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~ HKFRS 9, as issued in September 2014, amended paragraph 20 and deleted paragraphs 96, 97 and 98D. An entity shall apply those amendments when it applies HKFRS 9.
- 98G ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 98H *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to HKAS 12), issued in January 2016, amended paragraph 29 and added paragraphs 27A, 29A and the example following paragraph 26. An entity shall apply those amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, on initial application of the amendment, the change in the opening equity of the earliest comparative period may be recognised in opening retained earnings (or in another component of equity, as appropriate), without allocating the change between opening retained earnings and other components of equity. If an entity applies this relief, it shall disclose that fact.

Hong Kong Accounting Standard 16

Property, Plant and Equipment



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Depreciation: unit of measure

- IN10 An entity is required to determine the depreciation charge separately for each significant part of an item of property, plant and equipment.

Depreciation: depreciable amount

- IN11 An entity is required to measure the residual value of an item of property, plant and equipment as the amount it estimates it would receive currently for the asset if the asset were already of the age and in the condition expected at the end of its useful life.

Depreciation: depreciation period

- IN12 An entity is required to begin depreciating an item of property, plant and equipment when it is available for use and to continue depreciating it until it is derecognised, even if during that period the item is idle.

Derecognition: derecognition date

- IN13 An entity is required to derecognise the carrying amount of an item of property, plant and equipment that it disposes of on the date ~~the criteria for the sale of goods in HKAS 18 Revenue would be met~~ the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in HKFRS 15 Revenue from Contracts with Customers.
- IN14 An entity is required to derecognise the carrying amount of a part of an item of property, plant and equipment if that part has been replaced and the entity has included the cost of the replacement in the carrying amount of the item.

Derecognition: gain classification

- IN15 An entity cannot classify as revenue a gain it realises on the disposal of an item of property, plant and equipment.

- (e) aircraft;
 - (f) motor vehicles;
 - (g) furniture and fixtures; ~~and~~
 - (h) office equipment; and
 - (i) bearer plants.
- 38 The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.
- 39 **If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.**
- 40 **If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.**
- 41 The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.
- 42 The effects of taxes on income, if any, resulting from the revaluation of property, plant and equipment are recognised and disclosed in accordance with HKAS 12 *Income Taxes*.

Depreciation

- 43 **Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.**
- 44 An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.
- 45 A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.
- 46 To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

Derecognition

- 67 The carrying amount of an item of property, plant and equipment shall be derecognised:
- (a) on disposal; or
 - (b) when no future economic benefits are expected from its use or disposal.
- 68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless HKAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.
- 68A However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognised as revenue in accordance with ~~HKAS 18 Revenue~~ HKFRS 15 Revenue from Contracts with Customers. HKFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories.
- 69 The disposal of an item of property, plant and equipment may occur in a variety of ways (eg by sale, by entering into a finance lease or by donation). ~~In determining the date of disposal of an item, an entity applies the criteria in HKAS 18 for recognising revenue from the sale of goods of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in HKFRS 15. HKAS 17 applies to disposal by a sale and leaseback.~~
- 70 If, under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.
- 71 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.
- 72 ~~The amount of consideration receivable on disposal to be included in the gain or loss arising from the derecognition of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 reflecting the effective yield on the receivable determined in accordance with the requirements for determining the transaction price in paragraphs 47–72 of HKFRS 15. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in HKFRS 15.~~

Disclosure

- 73 The financial statements shall disclose, for each class of property, plant and equipment:
- (a) the measurement bases used for determining the gross carrying amount;
 - (b) the depreciation methods used;
 - (c) the useful lives or the depreciation rates used;
 - (d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
 - (e) a reconciliation of the carrying amount at the beginning and end of the period showing:
 - (i) additions;

80AB SSAP 17 Property, Plant and Equipment exempted charitable, government subvented and not-for-profit organisations whose long-term financial objective is other than to achieve operating profits (e.g. trade associations, clubs and retirement schemes) from compliance with its requirements. Those entities that have previously taken advantage of the exemption under SSAP 17 are permitted to deem the carrying amount of an item of property, plant and equipment immediately before applying this Standard on its effective date (or earlier) as the cost of that item. Depreciation on the deemed cost of an item of property, plant and equipment commences from the time at which this Standard is first applied. In the case where a carrying amount is used as a deemed cost for subsequent accounting, this fact and the aggregate of the carrying amounts for each class of property, plant and equipment presented shall be disclosed.

81B In the reporting period when *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) is first applied an entity need not disclose the quantitative information required by paragraph 28(f) of HKAS 8 for the current period. However, an entity shall present the quantitative information required by paragraph 28(f) of HKAS 8 for each prior period presented.

81C An entity may elect to measure an item of bearer plants at its fair value at the beginning of the earliest period presented in the financial statements for the reporting period in which the entity first applies *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) and use that fair value as its deemed cost at that date. Any difference between the previous carrying amount and fair value shall be recognised in opening retained earnings at the beginning of the earliest period presented.

Effective date

- 81** **An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.**
- 81a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).
- 81A An entity shall apply the amendments in paragraph 3 for annual periods beginning on or after 1 January 2006. If an entity applies HKFRS 6 for an earlier period, those amendments shall be applied for that earlier period.
- 81B HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 39, 40 and 73(e)(iv). An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 81C HKFRS 3 *Business Combinations* (as revised in 2008) amended paragraph 44. An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period.
- 81D Paragraphs 6 and 69 were amended and paragraph 68A was added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and at the same time apply the related amendments to HKAS 7 *Statement of Cash Flows*.
- 81E Paragraph 5 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted if an entity also applies the amendments to paragraphs 8, 9, 22, 48, 53, 53A, 53B, 54, 57 and 85B of HKAS 40 at the same time. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 81F HKFRS 13, issued in June 2011, amended the definition of fair value in paragraph 6, amended paragraphs 26, 35 and 77 and deleted paragraphs 32 and 33. An entity shall apply those amendments when it applies HKFRS 13.
- 81G *Annual Improvements 2009-2011 Cycle*, issued in June 2012, amended paragraph 8. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 81H *Annual Improvements to HKFRSs 2010-2012 Cycle*, issued in January 2014, amended paragraph 35 and added paragraph 80A. An entity shall apply that amendment for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 81I *Clarification of Acceptable Methods of Depreciation and Amortisation* (Amendments to HKAS 16 and HKAS 38), issued in June 2014, amended paragraph 56 and added paragraph 62A. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.
- 81J ~~This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.~~ HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 68A, 69 and 72. An entity shall apply those amendments when it applies HKFRS 15.

- 81K *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41), issued in August 2014, amended paragraphs 3, 6 and 37 and added paragraphs 22A and 81L–81M80B–80C. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively, in accordance with HKAS 8, except as specified in paragraph 81M80C.
- 81L ~~In the reporting period when *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) is first applied an entity need not disclose the quantitative information required by paragraph 28(f) of HKAS 8 for the current period. However, an entity shall present the quantitative information required by paragraph 28(f) of HKAS 8 for each prior period presented. [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 81M ~~An entity may elect to measure an item of bearer plants at its fair value at the beginning of the earliest period presented in the financial statements for the reporting period in which the entity first applies *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) and use that fair value as its deemed cost at that date. Any difference between the previous carrying amount and fair value shall be recognised in opening retained earnings at the beginning of the earliest period presented. [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~

Withdrawal of other pronouncements

- 82 This Standard supersedes SSAP 17 *Property, Plant and Equipment* (revised in 2001).
- 83 This Standard supersedes the following Interpretations: (a) Interpretation 1 *Costs of Modifying Existing Software* and Interpretation 5 *Property, Plant and Equipment—Compensation for the Impairment or Loss of Items*

- (b) income is not necessarily earned only at the culmination of an earning process, and in some cases it is arbitrary to determine when an earning process culminates;
 - (c) generally, under both measurement bases after recognition that are permitted under IAS 16, gain recognition is not deferred beyond the date at which assets are exchanged; and
 - (d) removing 'existing carrying amount' measurement of property, plant and equipment acquired in exchange for similar assets would increase the consistency of measurement of acquisitions of assets.
- BC20 The Board decided to require in IAS 16 that all items of property, plant and equipment acquired in exchange for non-monetary assets or a combination of monetary and non-monetary assets should be measured at fair value, except that, if the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be determined reliably, then the cost of the asset acquired in the exchange should be measured at the carrying amount of the asset given up.
- BC21 The Board added the 'commercial substance' test in response to a concern raised in the comments it received on the ED. This concern was that, under the Board's proposal, an entity would measure at fair value an asset acquired in a transaction that did not have commercial substance, ie the transaction did not have a discernible effect on an entity's economics. The Board agreed that requiring an evaluation of commercial substance would help to give users of the financial statements assurance that the substance of a transaction in which the acquired asset is measured at fair value (and often, consequentially, a gain on the disposal of the transferred asset is recognised in income) is the same as its legal form.
- BC22 The Board concluded that in evaluating whether a transaction has commercial substance, an entity should calculate the present value of the post-tax cash flows that it can reasonably expect to derive from the portion of its operations affected by the transaction. The discount rate should reflect the entity's current assessment of the time value of money and the risks specific to those operations rather than those that marketplace participants would make.
- BC23 The Board included the 'reliable measurement' test for using fair value to measure these exchanges to minimise the risk that entities could 'manufacture' gains by attributing inflated values to the assets exchanged. Taking into consideration its project for the convergence of IFRSs and US GAAP, the Board discussed whether to change the manner in which its 'reliable measurement' test is described. The Board observed this was unnecessary because it believes that its guidance and that contained in US GAAP are intended to have the same meaning.
- BC24 The Board decided to retain, in IAS 18 *Revenue*,^{*} its prohibition on recognising revenue from exchanges or swaps of goods or services of a similar nature and value. The Board has on its agenda a project on revenue recognition and does not propose to make any significant amendments to IAS 18 until that project is completed.

Measurement after recognition

Revaluation model

- BC25 The Board is taking part in research activities with national standard-setters on revaluations of property, plant and equipment. This research is intended to promote international convergence of standards. One of the most important issues is identifying the preferred measurement attribute for revaluations. This research could lead to proposals to amend IAS 16.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 also excludes from its scope non-monetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange.

Derecognition

Derecognition date

- BC34 The Board decided that an entity should apply the revenue recognition principle in IAS 18[#] for sales of goods to its gains from the sales of items of property, plant and equipment. The requirements in that principle ensure the representational faithfulness of an entity's recognised revenue. Representational faithfulness is also the appropriate objective for an entity's recognised gains. However, in IAS 16, the revenue recognition principle's criteria drive derecognition of the asset disposed of rather than recognition of the proceeds received. Applying the principle instead to the recognition of the proceeds might lead to the conclusion that an entity will recognise a deferred gain. Deferred gains do not meet the definition of a liability under the *Framework*. Thus, the Board decided that an entity does not derecognise an item of property, plant and equipment until the requirements in IAS 18 to recognise revenue on the sale of goods are met.

Gain classification

- BC35 Although the Board concluded that an entity should apply the recognition principle for revenue from sales of goods to its recognition of gains on disposals of items of property, plant and equipment, the Board concluded that the respective approaches to income statement display should differ. The Board concluded that users of financial statements would consider these gains and the proceeds from an entity's sale of goods in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows. This is because revenue from the sale of goods is typically more likely to recur in comparable amounts than are gains from sales of items of property, plant and equipment. Accordingly, the Board concluded that an entity should not classify as revenue gains on disposals of items of property, plant and equipment.

Assets held for rental to others^{*}

- BC35A The Board identified that, in some industries, entities are in the business of renting and subsequently selling the same assets.
- BC35B The Board noted that the Standard prohibits classification as revenue of gains arising from derecognition of items of property, plant and equipment. The Board also noted that paragraph BC35 states the reason for this is 'users of financial statements would consider these gains and the proceeds from an entity's sale of goods in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows.'
- BC35C Consistently with that reason, the Board concluded that entities whose ordinary activities include renting and subsequently selling the same assets should recognise revenue from both renting and selling the assets. In the Board's view, the presentation of gross selling revenue, rather than a net gain or loss on the sale of the assets, would better reflect the ordinary activities of such entities.
- BC35D The Board concluded that the disclosure requirements of IAS 16, IAS 2 and IAS 18[§] would lead an entity to disclose relevant information for users.
- BC35E The Board also concluded that paragraph 14 of IAS 7 *Statement of Cash Flows* should be amended to present within operating activities cash payments to manufacture or acquire such assets and cash receipts from rents and sales of such assets.

[#] IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 69 of IAS 16 for consistency with the requirements in IFRS 15.

^{*} Paragraphs BC35A–BC35F were added as a consequence of amendments to IAS 16 by *Improvements to IFRSs* issued in May 2008. At the same time, the Board also amended paragraph 6 by replacing the term 'net selling price' in the definition of 'recoverable amount' with 'fair value less costs to sell' for consistency with the wording used in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36.

[§] IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.

Hong Kong Accounting Standard 17

Leases



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Inception of the lease and commencement of the lease term

- BC16 The previous version of IAS 17 did not define the commencement of the lease term. It implicitly assumed that commencement (when the lease begins) and inception (when the agreement is entered into) are simultaneous. Some respondents questioned what should happen if there is a time lag between the two dates, particularly if the amounts change – for example, because the asset is under construction and the final cost is not known at inception. The Standard now specifies that recognition takes place at commencement, based on values measured at inception. However, if the lease is adjusted for changes in the lessor's costs between the inception of the lease and the commencement of the lease term, the effect of any such changes is deemed to have taken place at inception. These revisions are consistent with generally accepted accounting principles in Australia, Canada and the United States, and are consistent with the present accounting treatment of most ordinary purchases and sales.
- BC17 In agreeing on this treatment, the Board noted that measurement at commencement would have been more satisfactory in principle. However, this cannot be done properly within the framework of IAS 17 because the Standard generally requires a finance lease receivable or payable to be recognised at an amount based on the fair value of the asset, which is inappropriate at any date after inception.

Leases in the financial statements of lessors other than manufacturers and dealers

- BC18 Lessors may incur direct costs in negotiating a lease, such as commissions, brokers' fees and legal fees. The previous version of IAS 17 contained a choice on how to account for such costs—they might be either charged as an expense as incurred or allocated over the lease term. The choice of treatment applied to operating and finance leases. In the case of a finance lease, paragraph 33 of the previous version of IAS 17 stated that allocation over the lease term might be achieved by recognising the cost as an expense and, in the same period, recognising an equal amount of unearned finance income.
- BC19 The Board decided that this treatment was not in accordance with the *Framework for the Preparation and Presentation of Financial Statements*.^{*} Its effect was to recognise some future finance income as income and an asset at the commencement of the lease term. However, at that date, the *Framework*'s definitions of income and assets are not met. Therefore the Board decided that if direct costs incurred by lessors are to be allocated over the lease term, this should be achieved by including them in the carrying amount of the lease asset.
- BC20 The Board noted that standard-setters in Australia, Canada, France, Japan, the United Kingdom and the United States either permit or require initial direct costs to be allocated over the lease term. The Board also noted that other Standards permit or require the recognition of a range of similar costs in the carrying amount of assets, generally subject to those costs being directly attributable to the acquisition of the asset in question. Hence, for reasons of convergence and comparability with other Standards, the Board decided to require initial direct costs to be included in the carrying amount of the lease asset.
- BC21 For consistency with other Standards, in particular IAS 39 *Financial Instruments: Recognition and Measurement*,[#] the Board decided that recognition in the carrying amount of assets should be restricted to costs that are incremental and directly attributable to negotiating and arranging a lease.

^{*} IASC's *Framework for the Preparation and Presentation of Financial Statements* was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 17 was issued.

Hong Kong Accounting Standard 18

Revenue

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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HKAS 19 (2011)
Revised April–September 2018

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Accounting Standard 19 (2011)

Employee Benefits



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- (ii) even if the entity retains a legal obligation to pay the entire amount of the benefits directly, this legal obligation is a matter of form rather than substance.
- (b) A gross presentation would be an unnecessary change from current practice, which generally permits a net presentation. It would introduce excessive complexity into the standard, for limited benefit to users, given that paragraph 140(a) already requires disclosure of the gross amounts.
- (c) A gross approach may lead to measurement difficulties because of the interaction with the 10 per cent corridor that existed for the obligation before the amendments made to IAS 19 in 2011.
- (d) A net approach might be viewed as analogous to the treatment of joint and several liabilities under paragraph 29 of IAS 37. An entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable. The part of the obligation that is expected to be met by other parties is treated as a contingent liability.

BC181 Supporters of a gross approach advocated that approach for one or more of the following reasons:

- (a) Paragraph BC174 gives a justification for presenting defined benefit obligations net of plan assets. The explanation focuses on whether offsetting is appropriate. Part (c) of the 1998 definition focuses on offsetting. This suggests that assets that satisfy parts (a) and (b) of the definition, but fail part (c), should be treated in the same way as plan assets for recognition and measurement purposes, but should be shown gross in the balance sheet without offsetting.
- (b) If offsetting is allowed when condition (c) is not met, this would seem to be equivalent to permitting a net presentation for 'in-substance defeasance' and other analogous cases where IAS 32 indicates explicitly that offsetting is inappropriate. IASC rejected 'in-substance defeasance' for financial instruments (see IAS 39 *Financial Instruments: Recognition and Measurement*[#] paragraph AG59)[±] and there was no obvious reason to permit it in accounting for defined benefit plans. In these cases the entity retains an obligation that should be recognised as a liability and the entity's right to reimbursement from the plan is a source of economic benefits that should be recognised as an asset. Offsetting would be permitted if the conditions in paragraph 42 of IAS 32 are satisfied.
- (c) IASC decided in IAS 37 to require a gross presentation for reimbursements related to provisions, even though this was not previously general practice. There is no conceptual reason to require a different treatment for employee benefits.
- (d) Although some consider that a gross approach requires an entity to recognise assets that it does not control, others believe that this view is incorrect. A gross approach requires the entity to recognise an asset representing its right to receive reimbursement from the fund that holds those assets. It does not require the entity to recognise the underlying assets of the fund.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. The requirements in paragraph AG59 of IAS 39 were relocated to paragraph B3.3.3 of IFRS 9.

[±] In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. The requirements in paragraph AG59 of IAS 39 were relocated to paragraph AG3.3.3 of IFRS 9.

- BC185 When an entity retains a direct obligation to the employees, IASC acknowledged that the net presentation was inconsistent with the derecognition requirements for financial instruments in IAS 39* and with the offsetting requirements in IAS 32. However, in IASC's view, the restrictions on the use of the assets created a sufficiently strong link with the employee benefit obligations that a net presentation was more relevant than a gross presentation, even if the entity retained a direct obligation to the employees.
- BC186 IASC believed that such restrictions were unique to employee benefit plans and did not intend to permit this net presentation for other liabilities if the conditions then in IAS 32 and IAS 39 were not met. Accordingly, condition (a) in the new definition refers to the reason for the existence of the fund. IASC believed that an arbitrary restriction of this kind was the only practical way to permit a pragmatic exception to IASC's general offsetting criteria without permitting an unacceptable extension of this exception to other cases.
- BC187 In some plans in some countries, an entity is entitled to receive a reimbursement of employee benefits from a separate fund, but the entity has discretion to delay receipt of the reimbursement or to claim less than the full reimbursement. Some argue that this element of discretion weakens the link between the benefits and the reimbursement so much that a net presentation is not justifiable. They believe that the definition of plan assets should exclude assets held by such funds and that a gross approach should be used in such cases. IASC concluded that the link between the benefits and the reimbursement was strong enough in such cases that a net approach was still appropriate.
- BC188 IASC's proposal for extending the definition of plan assets was set out in exposure draft E67 *Pension Plan Assets*, published in July 2000. The vast majority of the 39 respondents to E67 supported the proposal.
- BC189 A number of respondents to E67 proposed a further extension of the definition to include particular insurance policies that have similar economic effects to funds whose assets qualify as plan assets under the revised definition proposed in E67. Accordingly, IASC extended the definition of plan assets to include some insurance policies (described in IAS 19 as qualifying insurance policies) that satisfy the same conditions as other plan assets. These decisions were implemented in amendments to IAS 19 approved by IASC in October 2000.
- BC190 A qualifying insurance policy is not necessarily an insurance contract as defined in IFRS 4 *Insurance Contracts*.

Plan assets—measurement

- BC191 IAS 19 before its revision in 1998 stated that plan assets are valued at fair value, but did not define fair value. However, other International Accounting Standards defined fair value as 'the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction'.[†] This might be taken to imply that no deduction is made for the estimated costs that would be necessary to sell the asset (in other words, it is a mid-market value, with no adjustment for transaction costs). However, some argue that a plan will eventually have to dispose of its assets in order to pay benefits. Consequently, IASC

* ~~In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.~~

[†] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value, describes the effect transaction costs have on a fair value measurement and addresses the application of bid and ask prices when measuring fair value.

concluded in E54 that plan assets should be measured at market value. Market value was defined, as in IAS 25 *Accounting for Investments*,^{*} as the amount obtainable from the sale of an asset, in an active market.

BC192 Some commentators on E54 felt that the proposal to measure plan assets at market value would not be consistent with IAS 22 *Business Combinations*[†] and with the measurement of financial assets as proposed in the discussion paper *Accounting for Financial Assets and Financial Liabilities* published by IASC's Financial Instruments Steering Committee in March 1997. Consequently, IASC decided that plan assets should be measured at fair value.

BC193 Some argue that concerns about volatility in reported profit should be countered by permitting or requiring entities to measure plan assets at a market-related value that reflects changes in fair value over an arbitrary period, such as five years. IASC believed that the use of market-related values would add excessive and unnecessary complexity and that the combination of the 'corridor' approach to actuarial gains and losses with deferred recognition outside the 'corridor' was sufficient to deal with concerns about volatility.[‡]

BC194 IASC decided that there should not be a different basis for measuring investments that have a fixed redemption value and those that match the obligations of the plan, or specific parts thereof. IAS 26 *Accounting and Reporting by Retirement Benefit Plans* permits such investments to be measured on an amortised cost basis.

Reimbursements: amendments issued in 2000

BC195 Paragraph 48 states that an entity recognises its rights under an insurance policy as an asset if the policy is held by the entity itself. IAS 19 before the amendments made in 2000 did not address the measurement of these insurance policies. The entity's rights under the insurance policy might be regarded as a financial asset. However, rights and obligations arising under insurance contracts are excluded from the scope of IAS 39.[§] In addition, IAS 39 does not apply to 'employers' rights and obligations under employee benefit plans, to which IAS 19 *Employee Benefits* applies'. Paragraphs 46–49 discuss insured benefits in distinguishing defined contribution plans and defined benefit plans, but this discussion does not deal with measurement.

BC196 In reviewing the definition of plan assets (see paragraphs BC178–BC190), IASC reviewed the treatment of insurance policies that an entity holds in order to fund employee benefits. Even under the revised definition adopted in 2000, the entity's rights under an insurance policy that is not a qualifying insurance policy (as defined in the 2000 revision of IAS 19) are not plan assets.

^{*} ~~IAS 25 was superseded by IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.~~

[†] IAS 22 was withdrawn in 2004 and replaced by IFRS 3 *Business Combinations*.

[‡] The amendments made in 2011 eliminated the 10 per cent corridor from IAS 19.

[§] ~~In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.~~

- (b) In financial statements for periods beginning before 1 January 2014, an entity need not provide comparatives for the disclosures about the sensitivity of the defined benefit obligation. The Board provided this exemption to provide sufficient lead time for entities to implement the necessary systems.

First-time adopters

- BC270 For entities adopting IFRSs for the first time, the amendments made in 2011 are to be applied retrospectively as required by IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The Board included a temporary exemption for entities adopting IFRSs to use paragraph 173(b) for the same reasons as given in paragraph BC269(b)*.

Early application

- BC271 The amendments made in 2011 will improve the accounting and, in particular, the disclosures provided by a reporting entity in relation to its participation in defined benefit plans. In addition, some of the amendments address existing problems in applying IAS 19 in practice. The Board noted that the majority of the amendments made in 2011 are permitted by the previous version of IAS 19. Consequently, the Board permitted early application of all the amendments made in 2011.

Transition provisions for *Defined Benefit Plans: Employee Contributions*

- BC271A In ED/2013/4, the IASB proposed retrospective application and to permit earlier application of the amendments. The majority of the respondents supported those proposals. Some respondents questioned whether retrospective application was practicable because some calculations might require information that is not readily available. The IASB observed that in current practice, contributions from employees or third parties are generally reduced from service cost without being attributed to periods of service. The proposed amendments are intended to provide relief so that entities can deduct contributions from service cost in the period in which the service is rendered, which was common practice prior to the 2011 amendments to IAS 19. The impact of retrospective application would therefore be minimal in those cases. Consequently, the IASB decided to retain the requirement for retrospective application.
- BC271B The amendments to IAS 19 published in 2011 are effective for annual periods beginning on or after 1 January 2013. In the IASB's view, the objective of the amendments published in 2013 is to provide relief in the accounting for contributions from employees or third parties and, therefore, the effective date should be set as early as possible, while allowing jurisdictions to have sufficient time to prepare for the new requirements. Consequently, the IASB decided that the effective date of the amendments should be 1 July 2014, with earlier application permitted.

* *Annual Improvement to IFRS Standards 2014-2016 Cycle*, issued in December 2016, amended IFRS 1 *First-time Adoption of International Financial Reporting Standards* by deleting the short-term exemption for first-time adopters (see paragraph BC99 of IFRS 1), because it was no longer applicable.

Annual Improvements to IFRSs 2012–2014 Cycle

BC271C *Annual Improvements to IFRSs 2012–2014 Cycle*, issued in September 2014, amended paragraph 83. The Board noted that for some entities a full retrospective application of the amendment could be burdensome. Consequently, the Board decided that the amendment should be applied from the beginning of the earliest comparative period presented in the first financial statements in which an entity applies the amendment. Any initial adjustment arising from the application of the amendment should be recognised in opening retained earnings of the earliest comparative period presented.

Summary of changes from the 2010 ED and 2005 ED: amendments issued in 2011

BC272 The main changes from the 2010 ED are:

- (a) The amendments do not specify where in profit or loss an entity should present the net interest component. The 2010 ED proposed that an entity should include the net interest component as part of finance cost in profit or loss.
- (b) The amendments require gains and losses on settlement to be included in service cost. The 2010 ED proposed that gains and losses on settlement should be included in remeasurements.
- (c) The amendments do not require the following disclosures proposed in the 2010 ED:
 - (i) the defined benefit obligation, excluding projected growth in salaries;
 - (ii) sensitivity of current service cost to changes in actuarial assumptions; and
 - (iii) a description of the process used to determine the demographic actuarial assumptions.
- (d) The amendments align the timing of recognition for plan amendments, termination benefits and restructuring costs. The 2010 ED proposed aligning the timing of recognition for plan amendments and termination benefits only.
- (e) The amendments do not:
 - (i) combine the post-employment and other long-term employee benefit categories, as had been proposed in the 2010 ED.

Hong Kong Accounting Standard 20

Accounting for Government Grants and Disclosure of Government Assistance



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Hong Kong Accounting Standard 20 *Accounting for Governments Grants and Disclosure of Government Assistance* (HKAS 20) is set out in paragraphs 1-486. All the paragraphs have equal authority. HKAS 20 should be read in the context of the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Statements* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

***Forgivable loans* are loans which the lender undertakes to waive repayment of under certain prescribed conditions.**

***Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13 *Fair Value Measurement*.)**

- 4 Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.
- 5 The receipt of government assistance by an entity may be significant for the preparation of the financial statements for two reasons. Firstly, if resources have been transferred, an appropriate method of accounting for the transfer must be found. Secondly, it is desirable to give an indication of the extent to which the entity has benefited from such assistance during the reporting period. This facilitates comparison of an entity's financial statements with those of prior periods and with those of other entities.
- 6 Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

Government grants

- 7 **Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:**
 - (a) **the entity will comply with the conditions attaching to them; and**
 - (b) **the grants will be received.**
- 8 A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.
- 9 The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government.
- 10 A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.
- 10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with ~~HKAS 39~~ HKFRS 9 ~~*Financial Instruments: Recognition and Measurement*~~. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with ~~HKAS 39~~ HKFRS 9 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.
- 11 Once a government grant is recognised, any related contingent liability or contingent asset is treated in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- 12 **Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.**

Effective date

- 41 **This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact and apply Hong Kong (SIC) Interpretation (HK(SIC)-Int) 10 *Government Assistance – No Specific Relation to Operating Activities* at the same time.**
- 41a This Standard supersedes SSAP 35 *Accounting for Government Grants and Disclosure of Government Assistance* (issued in March 2002).
- 42 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it added paragraph 29A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 43 Paragraph 37 was deleted and paragraph 10A added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments prospectively to government loans received in periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 44 ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~ [Deleted]
- 45 HKFRS 13, issued in June 2013, amended the definition of fair value in paragraph 3. An entity shall apply that amendment when it applies HKFRS 13.
- 46 *Presentation of Items of Other Comprehensive Income* (Amendment to HKAS 1), issued in July 2011, amended paragraph 29 and deleted paragraph 29A. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 47 [Deleted]
- 48 HKFRS 9, as issued in September 2014, amended paragraph 10A and deleted paragraphs 44 and 47. An entity shall apply those amendments when it applies HKFRS 9.

Basis for Conclusions on IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

This Basis for Conclusions accompanies, but is not part of, IAS 20.

HKAS 20 is based on IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. In approving HKAS 20, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 20. Accordingly, there are no significant differences between HKAS 20 and IAS 20. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 20 referred to below generally correspond with those in HKAS 20.

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in amending IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* as part of *Improvements to IFRSs* issued in May 2008.
- BC2 IAS 20 was developed by the International Accounting Standards Committee in 1983 and did not include a Basis for Conclusions. This Basis refers to the insertion of paragraphs 10A and 43 and the deletion of paragraph 37. Those changes require government loans with below-market rates of interest to be recognised and measured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*² and the benefit of the reduced interest to be accounted for using IAS 20.

Accounting for loans from government with a below-market rate of interest

- BC3 The Board identified an apparent inconsistency between the guidance in IAS 20 and IAS 39.* It related to the accounting for loans with a below-market rate of interest received from a government. IAS 20 stated that no interest should be imputed for such a loan, whereas IAS 39 required all loans to be recognised at fair value, thus requiring interest to be imputed to loans with a below-market rate of interest.
- BC4 The Board decided to remove this inconsistency. It believed that the imputation of interest provides more relevant information to a user of the financial statements. Accordingly the Board amended IAS 20 to require that loans received from a government that have a below-market rate of interest should be recognised and measured in accordance with IAS 39. The benefit of the government loan is measured at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised in the statement of financial position. This benefit is accounted for in accordance with IAS 20.
- BC5 Noting that applying IAS 39 to loans retrospectively may require entities to measure the fair value of loans at a past date, the Board decided that the amendment should be applied prospectively to new loans.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 20 was amended in 2008.

Hong Kong Accounting Standard 21

The Effects of Changes in Foreign Exchange Rates



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Introduction

- IN1 Hong Kong Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates* (HKAS 21) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 21

- IN2 The objectives of the HKICPA in issuing HKAS 21 were to reduce or eliminate alternatives, redundancies and conflicts within the HKFRSs, to deal with some convergence issues and to make other improvements.
- IN3 For HKAS 21 the HKICPA's main objective was to provide additional guidance on the translation method and on determining the functional and presentation currencies. The HKICPA did not reconsider the fundamental approach to accounting for the effects of changes in foreign exchange rates contained in HKAS 21.

The main features

- IN4 The main features of HKAS 21 are described below.

Scope

- IN5 The Standard excludes from its scope foreign currency derivatives that are within the scope of ~~HKAS 39~~ HKFRS 9 *Financial Instruments: Recognition and Measurement*. Similarly, the material on hedge accounting has been moved to HKAS 39 *Financial Instruments: Recognition and Measurement*.*

Definitions

- IN6 Two notions are used:
- functional currency, ie the currency of the primary economic environment in which the entity operates.
 - presentation currency, ie the currency in which financial statements are presented.

Definitions—functional currency

- IN7 When a reporting entity prepares financial statements, the Standard requires each individual entity included in the reporting entity—whether it is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)—to determine its functional currency and measure its results and financial position in that currency.

IN8 [Not used]

IN9 [Not used]

Reporting foreign currency transactions in the functional currency—recognition of exchange differences

IN10 [Not used]

Reporting foreign currency transactions in the functional currency—change in functional currency

- IN11 A change in functional currency is accounted for prospectively.

* In December 2013 the HKICPA replaced the hedge accounting requirements in HKAS 39 and relocated them to HKFRS 9.

Hong Kong Accounting Standard 21

The Effects of Changes in Foreign Exchange Rates

Objective

- 1 An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency. The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.
- 2 The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Scope

- 3 **This Standard shall be applied:**
 - (a) **in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of ~~HKAS 39~~ HKFRS 9 *Financial Instruments: Recognition and Measurement*;**
 - (b) **in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method; and**
 - (c) **in translating an entity's results and financial position into a presentation currency.**
- 4 ~~HKAS 39~~ HKFRS 9 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of ~~HKAS 39~~ HKFRS 9 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.
- 5 This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. ~~HKAS 39~~ HKFRS 9 applies to hedge accounting.
- 6 This Standard applies to the presentation of an entity's financial statements in a foreign currency and sets out requirements for the resulting financial statements to be described as complying with Hong Kong Financial Reporting Standards (HKFRSs). For translations of financial information into a foreign currency that do not meet these requirements, this Standard specifies information to be disclosed.
- 7 This Standard does not apply to the presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation (see HKAS 7 *Statement of Cash Flows*).

Definitions

- 8 **The following terms are used in this Standard with the meanings specified:**

Closing rate is the spot exchange rate at the end of the reporting period.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

- 24 The carrying amount of an item is determined in conjunction with other relevant Standards. For example, property, plant and equipment may be measured in terms of fair value or historical cost in accordance with HKAS 16 *Property, Plant and Equipment*. Whether the carrying amount is determined on the basis of historical cost or on the basis of fair value, if the amount is determined in a foreign currency it is then translated into the functional currency in accordance with this Standard.
- 25 The carrying amount of some items is determined by comparing two or more amounts. For example, the carrying amount of inventories is the lower of cost and net realisable value in accordance with HKAS 2 *Inventories*. Similarly, in accordance with HKAS 36 *Impairment of Assets*, the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount. When such an asset is non-monetary and is measured in a foreign currency, the carrying amount is determined by comparing:
- (a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (ie the rate at the date of the transaction for an item measured in terms of historical cost);¹ and
 - (b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (eg the closing rate at the end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or vice versa.

- 26 When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

Recognition of exchange differences

- 27 As noted in paragraph 3(a) and 5, ~~HKAS 39~~ HKFRS 9 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an entity to account for some exchange differences differently from the treatment of exchange differences required by this Standard. For example, ~~HKAS 39~~ HKFRS 9 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are recognised initially in other comprehensive income to the extent that the hedge is effective.
- 28 **Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32.**
- 29 When monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period.
- 30 **When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss shall be recognised in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.**
- 31 Other HKFRSs require some gains and losses to be recognised in other comprehensive income. For example, HKAS 16 requires some gains and losses arising on a revaluation of property, plant and equipment to be recognised in other comprehensive income. When such an asset is measured in a foreign currency, paragraph 23(c) of this Standard requires the revalued amount to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income.

- 48A In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:
- (a) when the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest in its former subsidiary after the partial disposal; and
 - (b) when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation.
- 48B On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.
- 48C On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.**
- 48D A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.
- 49 An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

Tax effects of all exchange differences

- 50 Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. HKAS 12 *Income Taxes* applies to these tax effects.

Disclosure

- 51 In paragraphs 53 and 55-57 references to 'functional currency' apply, in the case of a group, to the functional currency of the parent.
- 52 An entity shall disclose:
- (a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with ~~HKAS 39~~ **HKFRS 9**; and
 - (b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
- 53 When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.
- 54 When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency shall be disclosed.

- 60C ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~[Deleted]
- 60D Paragraph 60B was amended by *Improvements to HKFRSs* issued in May 2010. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted.
- 60E ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~[Deleted]
- 60F HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 3(b), 8, 11, 18, 19, 33, 44-46 and 48A. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 60G HKFRS 13, issued in June 2011, amended the definition of fair value in paragraph 8 and amended paragraph 23. An entity shall apply those amendments when it applies HKFRS 13.
- 60H *Presentation of items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 39. An entity shall apply that amendment when it applies HKAS 1 as amended in July 2011.
- 60I [Deleted]
- 60J HKFRS 9, as issued in September 2014, amended paragraphs 3, 4, 5, 27, and 52 and deleted paragraphs 60C, 60E and 60I. An entity shall apply those amendments when it applies HKFRS 9.
- 60K [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

Withdrawal of other pronouncements

- 61 This Standard supersedes SSAP 11 *Foreign Currency Translation* (revised in 2001).
- 62 [Not used]

HKAS 23 (Revised)
Revised ~~January 2017~~ September 2018

Effective for annual periods
beginning on or after 1 January 2009*

Hong Kong Accounting Standard 23 (Revised)

Borrowing Costs

* (a) HKSA 23 (Revised) is applicable for annual periods beginning on or after 1 January 2009. Earlier application is permitted. HKAS 23 (Revised) supersedes HKAS 23 issued in 2004.



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Hong Kong Accounting Standard 23

Borrowing Costs

Core principle

- 1 **Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.**

Scope

- 2 **An entity shall apply this Standard in accounting for borrowing costs.**
- 3 The Standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.
- 4 An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:
- (a) a qualifying asset measured at fair value, for example a biological asset within the scope of HKAS 41 *Agriculture*; or
 - (b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

Definitions

- 5 **This Standard uses the following terms with the meanings specified:**
- Borrowing costs* are interest and other costs that an entity incurs in connection with the borrowing of funds.**
- A qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.**
- 6 Borrowing costs may include:
- (a) interest expense calculated using the effective interest method as described in HKFRS 9 *Financial Instruments*; ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~;
 - (b) [deleted]
 - (c) [deleted]
 - (d) finance charges in respect of finance leases recognised in accordance with HKAS 17 *Leases*; and
 - (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Disclosure

- 26 An entity shall disclose:
- (a) the amount of borrowing costs capitalised during the period; and
 - (b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Transitional provisions

- 27 When application of this Standard constitutes a change in accounting policy, an entity shall apply the Standard to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the effective date.
- 28 However, an entity may designate any date before the effective date and apply the Standard to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

Effective date

- 29 An entity shall apply the Standard for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Standard from a date before 1 January 2009, it shall disclose that fact.
- 29A Paragraph 6 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 29B HKFRS 9, as issued in September 2014, amended paragraph 6. An entity shall apply that amendment when it applies HKFRS 9.

Withdrawal of HKAS 23 (issued 2004)

- 30 This Standard supersedes HKAS 23 *Borrowing Costs* issued in 2004.

Effective date and transition

- BC15 Development of a qualifying asset may take a long time. Additionally, some assets currently in use may have undergone and completed their production or construction process many years ago. If the entity has been following the accounting policy of immediately recognising borrowing costs as an expense, the costs of gathering the information required to capitalise them retrospectively and to adjust the carrying amount of the asset may exceed the potential benefits. Hence, the Board decided to require prospective application, which was supported by respondents to the exposure draft.
- BC16 The Board noted that the revisions would result in information that is more comparable between entities. On that basis, if an entity wished to apply the revised Standard from any date before the effective date, users of the entity's financial statements would receive more useful and comparable information than previously.
- BC17 Therefore, an entity is permitted to apply the revised Standard from any designated date before the effective date. However, if an entity applies the Standard from such an earlier date, it should apply the Standard to all qualifying assets for which the commencement date for capitalisation is on or after that designated date.
- BC18 The Board recognises that the Standard may require an entity that reconciles its IFRS financial statements to US GAAP to maintain two sets of capitalisation information—one set that complies with the requirements of IAS 23 and one that complies with the requirements of SFAS 34. The Board wishes to avoid imposing on such entities the need to maintain two sets of capitalisation information. Therefore, before the effective date, the Board will consider what actions it might take to avoid this outcome.

Differences between IAS 23 and SFAS 34

- BC19 The following paragraphs summarise the main differences between IAS 23 and SFAS 34.

Definition of borrowing costs

- BC20 IAS 23 uses the term “borrowing costs” whereas SFAS 34 uses the term “interest costs”. “Borrowing costs” reflects the broader definition in IAS 23, which encompasses interest and other costs, such as
- (a) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. ~~*, and~~
 - (b) ~~amortisation of ancillary costs incurred in connection with the arrangement of borrowings.~~

* In 2007 the Board was advised that some of the components of borrowing costs in paragraph 6 are broadly equivalent to the components of interest expense calculated using the effective interest method in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Consequently, Therefore, the Board amended paragraph 6 to refer to the relevant guidance in IAS 39 when describing the components of borrowing costs. Subsequently, IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

IAS 23 requires disclosure only of the amount of borrowing costs capitalised during the period. IAS 1 *Presentation of Financial Statements* requires the disclosure of finance costs for the period.

Consequential amendments to IAS 11 *Construction Contracts*

BC27 ~~[Deleted] IAS 11 paragraph 18 states that “costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs when the contractor adopts the allowed alternative treatment in IAS 23 *Borrowing Costs*.” The Board decided to delete the reference to IAS 23 in this paragraph because it is unnecessary. Attributing borrowing costs to contracts is not a matter of capitalisation. Rather, it is a matter of identifying the contract costs. The inclusion of borrowing costs in contract costs affects the presentation of borrowing costs in profit or loss. It does not affect the recognition of borrowing costs as specified in IAS 23.~~

HKAS 27 (2011)
Revised January 2017 September 2018

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Accounting Standard 27 (2011)

Separate Financial Statements



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Consolidation exemption available for non-public entities

- BC7 The Board decided that a parent that meets the criteria in paragraph 4(a) of IFRS 10 for exemption from the requirement to prepare consolidated financial statements should, in its separate financial statements, account for those subsidiaries in the same way as other parents, joint venturers with interests in joint ventures or investors in associates account for investments in their separate financial statements. The Board draws a distinction between accounting for such investments as equity investments and accounting for the economic entity that the parent controls. In relation to the former, the Board decided that each category of investment should be accounted for consistently.
- BC8 The Board decided that the same approach to accounting for investments in separate financial statements should apply irrespective of the circumstances for which they are prepared. Thus, a parent that presents consolidated financial statements, and a parent that does not because it is exempted, should present the same form of separate financial statements.

Investment entities

- BC8A *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), issued in October 2012, introduced an exception to the principle in IFRS 10 that all subsidiaries shall be consolidated. The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*,^{*} if IFRS 9 has not yet been adopted) instead of consolidating those subsidiaries. Consequently, the Board decided to amend IAS 27 to require an investment entity to also measure its investments in subsidiaries at fair value through profit or loss in its separate financial statements. The Board also made corresponding amendments to the disclosure requirements for an investment entity's separate financial statements, noting that if an investment entity prepares separate financial statements as its only financial statements, it is still appropriate for the investment entity to make the disclosures otherwise required in IFRS 12 about its interests in subsidiaries.

Measurement of investments in subsidiaries, joint ventures and associates in separate financial statements

2003 revision

- BC9 IAS 27 (as revised by the Board's predecessor body in 2000) permitted entities to measure investments in subsidiaries in any one of three ways in the parent's separate financial statements. These were at cost, using the equity method, or as available-for-sale[#] financial assets in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.^{*} IAS 28 *Investments in Associates* permitted the same choices for investments in associates in separate financial statements, and IAS 31 *Interests in Joint Ventures* stated that IAS 31 did not indicate a preference for any particular treatment for accounting for interests in joint ventures in a joint venturer's separate financial statements. However, in 2003 the Board decided to require the use of cost or IAS 39 for all investments included in separate financial statements and to remove the equity method as one of the measurement options.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

Dissent of Mary E Barth and Philippe Danjou from *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 and IAS 27) issued in May 2008

Cross-references have been updated.

- DO1 Professor Barth and Mr Danjou voted against the publication of *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements*). The reasons for their dissent are set out below.
- DO2 These Board members disagree with the **requirement** in paragraphs 13 and 14 of IAS 27 that when a reorganisation satisfies the criteria specified in those paragraphs and the resulting new parent accounts for its investment in the original parent at cost in accordance with paragraph 10(a) of IAS 27, the new parent must measure the 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 reorganisation.
- DO3 These Board members acknowledge that a new parent could choose to apply paragraph 10(b) of IAS 27 and account for its investment in the original parent in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.^{*} However, the new parent then would be required to account for the investment in accordance with IAS 39 in subsequent periods and to account for all other investments in the same category in accordance with IAS 39.
- DO4 These Board members also acknowledge, as outlined in paragraph BC23 of the Basis for Conclusions on IAS 27, that this type of reorganisation is different from other types of reorganisations in that the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation, as are the interests of the owners of the original parent in the net assets of those groups. Therefore, using the previous carrying amount to measure the cost of the new parent's investment in the original parent might be appropriate on the basis that the separate financial statements of the new parent would reflect its position as part of a pre-existing group.
- DO5 However, these Board members believe that it is inappropriate to preclude a new parent from measuring the cost of its investment in the original parent at the fair value of the shares that it issues as part of the reorganisation. Separate financial statements are prepared to reflect the parent as a separate legal entity (ie not considering that the entity might be part of a group). Although such a reorganisation does not change the assets and liabilities of the group and therefore should have no accounting effect at the consolidated level, from the perspective of the new parent as a separate legal entity, its position has changed—it has issued shares and acquired an investment that it did not have previously. Also, in many jurisdictions, commercial law or corporate governance regulations require entities to measure new shares that they issue at the fair value of the consideration received for the shares.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that previously were within the scope of IAS 39.

HKAS 28 (2011)
Revised January ~~January~~ September 2018

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Accounting Standard 28 (2011)

Investments in Associates and Joint Ventures



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Hong Kong Accounting Standard 28 *Investments in Associates and Joint Ventures* (HKAS 28) is set out in paragraphs 1–47. All the paragraphs have equal authority. HKAS 28 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

- IN1 Hong Kong Accounting Standard 28 *Investments in Associates and Joint Ventures* (HKAS 28) 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.
- IN2 The Standard is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

Main features of the Standard

- IN3 HKAS 28 (as amended in 2011) is to be applied by all entities that are investors with joint control of, or significant influence over, an investee.
- IN4 The Standard defines significant influence as the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
- IN5 HKFRS 11 *Joint Arrangements* establishes principles for the financial reporting of parties to joint arrangements. It defines joint control as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
- IN6 An entity applies HKFRS 11 to determine the type of joint arrangement in which it is involved. Once it has determined that it has an interest in a joint venture, the entity recognises an investment and accounts for it using the equity method in accordance with HKAS 28 (as amended in 2011), unless the entity is exempted from applying the equity method as specified in the Standard.

Equity method

- IN7 The Standard defines the equity method as a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes its share of the profit or loss of the investee and the other comprehensive income of the investor includes its share of other comprehensive income of the investee.
- IN8 An entity uses the equity method to account for its investments in associates or joint ventures in its consolidated financial statements. An entity that does not have any subsidiaries also uses the equity method to account for its investments in associates or joint ventures in its financial statements even though those are not described as consolidated financial statements. An entity could elect to use the equity method in its separate financial statements that it presents in accordance with HKAS 27 *Separate Financial Statements*.

Exemptions from applying the equity method

- IN9 The Standard provides exemptions from applying the equity method similar to those provided in HKFRS 10 *Consolidated Financial Statements* for parents not to prepare consolidated financial statements.
- IN10 The Standard also provides exemptions from applying the equity method when the investment in the associate or joint venture is held by, or is held indirectly through, venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds. Those investments in associates and joint ventures may be measured at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments*.

Disclosure

- IN11 The disclosure requirements for entities with joint control of, or significant influence over, an investee are specified in HKFRS 12 *Disclosure of Interests in Other Entities*.

Hong Kong Accounting Standard 28

Investments in Associates and Joint Ventures

Objective

- 1 The objective of this Standard is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

Scope

- 2 This Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee.

Definitions

- 3 The following terms are used in this Standard with the meanings specified:

An associate is an entity over which the investor has significant influence.

Consolidated financial statements are the financial statements of a group in which assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

The *equity method* is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

A joint arrangement is an arrangement of which two or more parties have joint control.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A joint venturer is a party to a joint venture that has joint control of that joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

- 4 The following terms are defined in paragraph 4 of HKAS 27 *Separate Financial Statements* and in Appendix A of HKFRS 10 *Consolidated Financial Statements* and are used in this Standard with the meanings specified in the HKFRSs in which they are defined:
- control of an investee
 - group
 - parent
 - separate financial statements
 - subsidiary.

Significant influence

- 5 If an entity holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.
- 6 The existence of significant influence by an entity is usually evidenced in one or more of the following ways:
- (a) representation on the board of directors or equivalent governing body of the investee;
 - (b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
 - (c) material transactions between the entity and its investee;
 - (d) interchange of managerial personnel; or
 - (e) provision of essential technical information.
- 7 An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

- 8 In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights.
- 9 An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.

Equity method

- 10 Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the investee's profit or loss is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in the investor's other comprehensive income (see HKAS 1 *Presentation of Financial Statements*).
- 11 The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate or a joint venture because the distributions received may bear little relation to the performance of the associate or joint venture. Because the investor has joint control of, or significant influence over, the investee, the investor has an interest in the associate's or joint venture's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of the profit or loss of such an investee. As a result, application of the equity method provides more informative reporting of the investor's net assets and profit or loss.
- 12 When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments, unless paragraph 13 applies.
- 13 In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.

- 14 HKFRS 9 *Financial Instruments* does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture, the instruments are not subject to HKFRS 9. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with HKFRS 9.
- 15 Unless an investment, or a portion of an investment, in an associate or a joint venture is classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, the investment, or any retained interest in the investment not classified as held for sale, shall be classified as a non-current asset.

Application of the equity method

- 16 An entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method except when that investment qualifies for exemption in accordance with paragraphs 17–19.

Exemptions from applying the equity method

- 17 An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in paragraph 4(a) of HKFRS 10 or if all the following apply:
- (a) The entity is a wholly-owned subsidiary, or is a 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.
 - (b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
 - (c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market.
 - (d) The ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with HKFRSs or International Financial Reporting Standards, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with HKFRS 10 or IFRS 10.
- 18 When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure ~~that investments in those associates and joint ventures~~ at fair value through profit or loss in accordance with HKFRS 9. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture.

- 19 When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with HKFRS 9 regardless of whether the venture capital organisation, or the mutual fund, unit trust and similar entities including investment-linked insurance funds, has significant influence over that portion of the investment. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds.

Classification as held for sale

- 20 An entity shall apply HKFRS 5 to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale. Any retained portion of an investment in an associate or a joint venture that has not been classified as held for sale shall be accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal takes place, an entity shall account for any retained interest in the associate or joint venture in accordance with HKFRS 9 unless the retained interest continues to be an associate or a joint venture, in which case the entity uses the equity method.
- 21 When an investment, or a portion of an investment, in an associate or a joint venture previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using the equity method retrospectively as from the date of its classification as held for sale. Financial statements for the periods since classification as held for sale shall be amended accordingly.

Discontinuing the use of the equity method

- 22 An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:
- (a) If the investment becomes a subsidiary, the entity shall account for its investment in accordance with HKFRS 3 *Business Combinations* and HKFRS 10.
 - (b) If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9. The entity shall recognise in profit or loss any difference between:
 - (i) the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and
 - (ii) the carrying amount of the investment at the date the equity method was discontinued.
 - (c) When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognised in other comprehensive income in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

- 23 Therefore, if a gain or loss previously recognised in other comprehensive income by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities, the entity reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the equity method is discontinued. For example, if an associate or a joint venture has cumulative exchange differences relating to a foreign operation and the entity discontinues the use of the equity method, the entity shall reclassify to profit or loss the gain or loss that had previously been recognised in other comprehensive income in relation to the foreign operation.
- 24 **If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.**

Changes in ownership interest

- 25 If an entity's ownership interest in an associate or a joint venture is reduced, but the investment continues to be classified either as an associate or a joint venture respectively, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities.

Equity method procedures

- 26 Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in HKFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.
- 27 A group's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 35 -36A).
- 28 Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor. 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.
- 29 When downstream transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognised in full by the investor. When upstream transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, the investor shall recognise its share in those losses.

- 30 The contribution of a non-monetary asset to an associate or a joint venture in exchange for an equity interest in the associate or joint venture shall be accounted for in accordance with paragraph 28, except when the contribution lacks commercial substance, as that term is described in HKAS 16 *Property, Plant and Equipment*. If such a contribution lacks commercial substance, the gain or loss is regarded as unrealised and is not recognised unless paragraph 31 also applies. Such unrealised gains and losses shall be eliminated against the investment accounted for using the equity method and shall not be presented as deferred gains or losses in the entity's consolidated statement of financial position or in the entity's statement of financial position in which investments are accounted for using the equity method.
- 31 If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognises in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.
- 32 An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:
- (a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.
 - (b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment.

- 33 **The most recent available financial statements of the associate or joint venture are used by the entity in applying the equity method. When the end of the reporting period of the entity is different from that of the associate or joint venture, the associate or joint venture prepares, for the use of the entity, financial statements as of the same date as the financial statements of the entity unless it is impracticable to do so.**
- 34 **When, in accordance with paragraph 33, the financial statements of an associate or a joint venture used in applying the equity method are prepared as of a date different from that used by the entity, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the entity's financial statements. In any case, the difference between the end of the reporting period of the associate or joint venture and that of the entity shall be no more than three months. The length of the reporting periods and any difference between the ends of the reporting periods shall be the same from period to period.**

- 35 The entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.**
- 36 Except as described in paragraph 36A, if an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to make the associate's or joint venture's accounting policies conform to those of the entity when the associate's or joint venture's financial statements are used by the entity in applying the equity method.
- 36A Notwithstanding the requirement in paragraph 36, if an entity that is not itself an investment entity has an interest in an associate or joint venture that is an investment entity, the entity may, when applying the equity method, elect to retain the fair value measurement applied by that investment entity associate or joint venture to the investment entity associate's or joint venture's interests in subsidiaries. This election is made separately for each investment entity associate or joint venture, at the later of the date on which (a) the investment entity associate or joint venture is initially recognised; (b) the associate or joint venture becomes an investment entity; and (c) the investment entity associate or joint venture first becomes a parent.
- 37 If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity computes its share of profit or loss after adjusting for the dividends on such shares, whether or not the dividends have been declared.
- 38 If an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture. Such items may include preference shares and long-term receivables or loans, but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognised using the equity method in excess of the entity's investment in ordinary shares are applied to the other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (ie priority in liquidation).
- 39 After the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports profits, the entity resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Impairment losses

- 40 After application of the equity method, including recognising the associate's or joint venture's losses in accordance with paragraph 38, the entity applies ~~HKAS 39 Financial Instruments: Recognition and Measurement to determine whether it is necessary to recognise any additional impairment loss with respect to its net investment in the associate or joint venture. paragraphs 41A-41C to determine whether there is any objective evidence that its net investment in the associate or joint venture is impaired.~~
- 41 The entity ~~also applies HKAS 39 to determine whether any additional impairment loss is recognised with respect to its interest in the associate or joint venture the~~ impairment requirements in HKFRS 9 to its other interests in the associate or joint

venture that are in the scope of HKFRS 9 and that does not constitute part of the net investment and the amount of that impairment loss.

41A The net investment in an associate or joint venture is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows from the net investment that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that the net investment is impaired includes observable data comes to the attention of the entity about the following loss events:

- (a) significant financial difficulty of the associate or joint venture;
- (b) a breach of contract, such as a default or delinquency in payments by the associate or joint venture;
- (c) the entity, for economic or legal reasons relating to its associate's or joint venture's financial difficulty, granting to the associate or joint venture a concession that the entity would not otherwise consider;
- (d) it becoming probable that the associate or joint venture will enter bankruptcy or other financial reorganisation; or
- (e) the disappearance of an active market for the net investment because of financial difficulties of the associate or joint venture.

41B The disappearance of an active market because the associate's or joint venture's equity of financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an associate's or joint venture's credit rating or a decline in the fair value of the associate or joint venture, is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.

41C In addition to the types of events in paragraph 41A, objective evidence of impairment for the net investment in the equity instruments of the associate or joint venture includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the associate or joint venture operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

- 42 Because goodwill that forms part of the carrying amount of ~~an~~ the net investment in an associate or a joint venture is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in HKAS 36 *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested for impairment in accordance with HKAS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount; whenever application of ~~HKAS 39 paragraphs 41A-41C~~ indicates that the net investment may be impaired. An impairment loss recognised in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the net investment in the associate or joint venture. Accordingly, any reversal of that impairment loss is recognised in accordance with HKAS 36 to the extent that the recoverable amount of the net investment subsequently increases. In determining the value in use of the net investment, an entity estimates:
- (a) its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from 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 from its ultimate disposal.

Using appropriate assumptions, both methods give the same result.

- 43 The recoverable amount of an investment in an associate or a joint venture shall be assessed for each associate or joint venture, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

Separate financial statements

- 44 An investment in an associate or a joint venture shall be accounted for in the entity's separate financial statements in accordance with paragraph 10 of HKAS 27 (as amended in 2011).

Effective date and transition

- 45 An entity shall apply this Standard for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies this Standard earlier, it shall disclose that fact and apply HKFRS 10, HKFRS 11 *Joint Arrangements*, HKFRS 12 *Disclosure of Interests in Other Entities* and HKAS 27 (as amended in 2011) at the same time.
- 45A ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~ HKFRS 9, as issued in September 2014, amended paragraphs 40-42 and added paragraphs 41A-41C. An entity shall apply those amendments when it applies HKFRS 9.
- 45B *Equity Method in Separate Financial Statements* (Amendments to HKAS 27), issued in September 2014, amended paragraph 25. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies that amendment for an earlier period, it shall disclose that fact.
- 45C ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~

- 45D *Investment Entities: Applying the Consolidation Exception* (Amendments to HKFRS 10, HKFRS 12 and HKAS 28), issued in January 2015, amended paragraphs 17, 27 and 36 and added paragraph 36A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.
- 45E *Annual Improvements to HKFRS Standards 2014-2016 Cycle*, issued in March 2017, amended paragraphs 18 and 36A. An entity shall apply those amendments retrospectively in accordance with HKAS 8 for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

References to HKFRS 9

- 46 If an entity applies this Standard but does not yet apply HKFRS 9, any reference to HKFRS 9 shall be read as a reference to HKAS 39.

Withdrawal of HKAS 28 (2004)

- 47 This Standard supersedes HKAS 28 *Investments in Associates* (issued in 2004)

Appendix

Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared in June 2011 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 28.

The International Accounting Standard comparable with HKAS 28 is IAS 28 *Investments in Associates and Joint Ventures*.

There are no major textual differences between HKAS 28 and IAS 28.

Appendix

Amendments to HKFRS 10 and HKAS 28 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture*

The following sets out amendments required for this Standard resulting from amendments to HKFRS 10 and HKAS 28 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

Paragraphs 28 and 30 are amended and paragraphs 31A–31B and 45A are added. Deleted text is struck through and new text is underlined. Paragraphs 29 and 31 are reproduced for ease of reference, but are not amended.

Equity method procedures

...

- 28 Gains and losses resulting from ‘upstream’ and ‘downstream’ transactions involving assets that do not constitute a business, as defined in HKFRS 3, between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity’s financial statements only to the extent of unrelated investors’ interests in the associate or joint venture. ‘Upstream’ transactions are, for example, sales of assets from an associate or a joint venture to the investor. The entity’s share in the associate’s or the joint venture’s gains or losses resulting from these transactions is eliminated. ‘Downstream’ transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. ~~The investor’s share in the associate’s or joint venture’s gains or losses resulting from these transactions is eliminated.~~
- 29 When downstream transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognised in full by the investor. When upstream transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, the investor shall recognise its share in those losses.
- 30 The gain or loss resulting from the contribution of a non-monetary assets that do not constitute a business, as defined in HKFRS 3, to an associate or a joint venture in exchange for an equity interest in the that associate or joint venture shall be accounted for in accordance with paragraph 28, except when the contribution lacks commercial substance, as that term is described in HKAS 16 *Property, Plant and Equipment*. If such a contribution lacks commercial substance, the gain or loss is regarded as unrealised and is not recognised unless paragraph 31 also applies. Such unrealised gains and losses shall be eliminated against the investment accounted for using the equity method and shall not be presented as deferred gains or losses in the entity’s consolidated statement of financial position or in the entity’s statement of financial position in which investments are accounted for using the equity method.
- 31 If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognises in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.

31A The gain or loss resulting from a downstream transaction involving assets that constitute a business, as defined in HKFRS 3, between an entity (including its consolidated subsidiaries) and its associate or joint venture is recognised in full in the investor's financial statements.

31B An entity might sell or contribute assets in two or more arrangements (transactions). When determining whether assets that are sold or contributed constitute a business, as defined in HKFRS 3, an entity shall consider whether the sale or contribution of those assets is part of multiple arrangements that should be accounted for as a single transaction in accordance with the requirements in paragraph B97 of HKFRS 10.

...

Paragraph 45C is amended. New text relating to the 2014 Amendments is underlined. New text relating to the 2015 Amendments is underlined and shaded in grey. Deleted text relating to the 2015 Amendments is struck through and shaded in grey.

Effective date and transition

...

45C *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to HKFRS 10 and HKAS 28), issued in October 2014, amended paragraphs 28 and 30 and added paragraphs 31A–31B. An entity shall apply those amendments prospectively to the sale or contribution of assets occurring in annual periods beginning on or after ~~1 January 2016~~ a date to be determined. Earlier application is permitted. If an entity applies those amendments earlier, it shall disclose that fact.

Appendix

Amendments to HKAS 28 *Long-term Interests in Associates and Joint Ventures*

The following sets out amendments required for this Standard resulting from amendments to HKAS 28 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

Paragraphs 14A and 45G–45K are added and paragraph 41 is deleted. Deleted text is struck through.

Equity method

- 14A An entity also applies HKFRS 9 to other financial instruments in an associate or joint venture to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture (see paragraph 38). An entity applies HKFRS 9 to such long-term interests before it applies paragraph 38 and paragraphs 40–43 of this Standard. In applying HKFRS 9, the entity does not take account of any adjustments to the carrying amount of long-term interests that arise from applying this Standard.

Application of the equity method

- 41 ~~[Deleted] The entity applies the impairment requirements in HKFRS 9 to its other interests in the associate or joint venture that are in the scope of HKFRS 9 and that do not constitute part of the net investment.~~

Effective date and transition

- 45G *Long-term Interests in Associates and Joint Ventures*, issued in January 2018, added paragraph 14A and deleted paragraph 41. An entity shall apply those amendments retrospectively in accordance with HKAS 8 for annual reporting periods beginning on or after 1 January 2019, except as specified in paragraphs 45H–45K. Earlier application is permitted. If an entity applies those amendments earlier, it shall disclose that fact.
- 45H An entity that first applies the amendments in paragraph 45G at the same time it first applies HKFRS 9 shall apply the transition requirements in HKFRS 9 to the long-term interests described in paragraph 14A.
- 45I An entity that first applies the amendments in paragraph 45G after it first applies HKFRS 9 shall apply the transition requirements in HKFRS 9 necessary for applying the requirements set out in paragraph 14A to long-term interests. For that purpose, references to the date of initial application in HKFRS 9 shall be read as referring to the beginning of the annual reporting period in which the entity first applies the amendments (the date of initial application of the amendments). The entity is not required to restate prior periods to reflect the application of the amendments. The entity may restate prior periods only if it is possible without the use of hindsight.

- 45J When first applying the amendments in paragraph 45G, an entity that applies the temporary exemption from HKFRS 9 in accordance with HKFRS 4 *Insurance Contracts* is not required to restate prior periods to reflect the application of the amendments. The entity may restate prior periods only if it is possible without the use of hindsight.
- 45K If an entity does not restate prior periods applying paragraph 45I or paragraph 45J, at the date of initial application of the amendments it shall recognise in the opening retained earnings (or other component of equity, as appropriate) any difference between:
- (a) the previous carrying amount of long-term interests described in paragraph 14A at that date; and
 - (b) the carrying amount of those long-term interests at that date.

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Basis for Conclusions on IAS 28 *Investments in Associates and Joint Ventures*

This Basis for Conclusions accompanies, but is not part of, IAS 28.

HKAS 28 is based on IAS 28 *Investments in Associates and Joint Ventures*. In approving HKAS 28, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 28. Accordingly, there are no significant differences between HKAS 28 and IAS 28. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 28 referred to below generally correspond with those in HKAS 28.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on amending IAS 28 *Investments in Associates* in 2011. Individual Board members gave greater weight to some factors than to others.
- BC2 The amendment of IAS 28 resulted from the Board's project on joint ventures. When discussing that project, the Board decided to incorporate the accounting for joint ventures into IAS 28 because the equity method is applicable to both joint ventures and associates.
- BC3 As a result, the title of IAS 28 was changed to *Investments in Associates and Joint Ventures*. Because the Board's intention was not to reconsider the fundamental approach to the accounting for investments in associates established by IAS 28, the Board has incorporated into its Basis for Conclusions on IAS 28 material from the Basis for Conclusions on IAS 28 (as revised in 2003) that the Board has not reconsidered.

The structure of IAS 28 and the Board's deliberations

- BC4 IAS 28 as amended in 2011 superseded IAS 28 (as revised in 2003 and amended in 2010). As stated in paragraph BC3, in amending IAS 28, the Board did not reconsider all the Standard's requirements. The requirements in paragraphs 5–11, 15, 22–23, 25–28 and 32–43 relate to the assessment of significant influence and to the equity method and its application, and paragraphs 12–14 relate to the accounting for potential voting rights. With the exception of the Board's decision to incorporate the accounting for joint ventures into IAS 28, those paragraphs were carried forward from IAS 28 and from the Guidance on Implementing IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* that was withdrawn when IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IAS 28 (as amended in 2011) were issued. As a result, those paragraphs were not reconsidered by the Board.
- BC5 When revised in 2003 IAS 28 was accompanied by a Basis for Conclusions summarising the considerations of the Board, as constituted at the time, in reaching its conclusions. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard.

- BC6 The Board has incorporated into its Basis for Conclusions on IAS 28 (as amended in 2011) material from the previous Basis for Conclusions because it discusses matters that the Board has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references have been updated accordingly and minor necessary editorial changes have been made.
- BC7 One Board member dissented from an amendment to IAS 28 issued in May 2008, which has been carried forward to IAS 28 (as amended in 2011). His dissenting opinion is also set out after this Basis for Conclusions.
- BC8 The requirements in paragraphs 2, 16–21, 24 and 29–31 relate to matters addressed within the joint ventures project that led to amendments to IAS 28. Paragraphs describing the Board's considerations in reaching its conclusions on IAS 28 are numbered with the prefix BC.
- BC9 As part of its project on consolidation, the Board is examining how an investment entity accounts for its interests in subsidiaries, joint ventures and associates. The outcome might affect how organisations such as venture capital organisations, or mutual funds, unit trusts and similar entities account for their interests in joint ventures and associates. The Board expects to publish later in 2011 an exposure draft on investment entities.^{1, 2}

Scope

- BC10 During its redeliberation of the exposure draft ED 9 *Joint Arrangements*, the Board reconsidered the scope exception of IAS 31 that had also been proposed in ED 9. The Board concluded that the scope exception in ED 9 for interests in joint ventures held by venture capital organisations, or mutual funds, unit trusts and similar entities, including investment-linked insurance funds, that are measured at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* is more appropriately characterised as a measurement exemption, and not as a scope exception.
- BC11 The Board observed that IAS 28 had a similar scope exception for investments in associates held by venture capital organisations, or mutual funds, unit trusts and similar entities, including investment-linked insurance funds, that are measured at fair value through profit or loss in accordance with IFRS 9.
- BC12 The Board observed that the scope exception in ED 9 and IAS 28 related not to the fact that these arrangements do not have the characteristics of joint arrangements or those investments are not associates, but to the fact that for investments held by venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds, fair value measurement provides more useful information for users of the financial statements than would application of the equity method.

¹ In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which required investment entities, as defined in IFRS 10 *Consolidated Financial Statements*, to measure their investments in subsidiaries, other than those providing investment-related services or activities, at fair value through profit or loss. The amendments did not introduce any new accounting requirements for investments in associates or joint ventures.

² In December 2014, the IASB issued *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28). The amendments introduced relief to permit a non-investment entity investor in an associate or joint venture that is an investment entity to retain the fair value through profit or loss measurement applied by the associate or joint venture to its subsidiaries (see paragraphs BC46A–BC46G).

- BC13 Accordingly, the Board decided to maintain the option that permits venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds to measure their interests in joint ventures and associates at fair value through profit or loss in accordance with IFRS 9, but clarified that this is an exemption from the requirement to measure interests in joint ventures and associates using the equity method, rather than an exception to the scope of IAS 28 for the accounting for joint ventures and associates held by those entities.
- BC14 As a result of that decision and of the decision to incorporate the accounting for joint ventures into IAS 28, the Board decided that IAS 28 should be applied to the accounting for investments held by all entities that have joint control of, or significant influence over, an investee.

Significant influence

Potential voting rights

- BC15 In its deliberation of the amendments to IAS 28, the Board considered whether the requirements now in paragraphs 7–9 of IAS 28 regarding potential voting rights when assessing significant influence should be changed to be consistent with the requirements developed in the consolidation project.
- BC16 The Board observed that the definition of significant influence in IAS 28 (ie ‘the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies’) was related to the definition of control as it was defined in IAS 27. The Board had not considered the definition of significant influence when it amended IAS 28 and concluded that it would not be appropriate to change one element of significant influence in isolation. Any such consideration should be done as part of a wider review of the accounting for associates.

Application of the equity method

Temporary joint control and significant influence (2003 revision)

- BCZ17 In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* the Board decided not to exempt an entity from applying the equity method for accounting for its investments in joint ventures and associates when joint control of, or significant influence over, an investee is intended to be temporary.

Severe long-term restrictions impairing ability to transfer funds to the investor (2003 revision)

- BCZ18 The Board decided not to exempt an entity from applying the equity method for accounting for its investments in joint ventures or associates when severe long-term restrictions impaired a joint venture or an associate’s ability to transfer funds to the investor. It did so because such circumstances may not preclude the entity’s joint control of, or significant influence over, the joint venture or the associate. The Board decided that an entity should, when assessing its ability to exercise joint control of, or significant influence over, an investee, consider restrictions on the transfer of funds from the joint venture or from the associate to the entity. In themselves, such restrictions do not preclude the existence of joint control or significant influence.

Non-coterminous year-ends (2003 revision)

BCZ19 The exposure draft that preceded the revision of IAS 28 in 2003 proposed to limit to three months any difference between the reporting dates of an entity and its associate or its joint venture when applying the equity method. Some respondents to that exposure draft believed that it could be impracticable for the entity to prepare financial statements as of the same date when the date of the entity's financial statements and those of the associate or joint venture differ by more than three months. The Board noted that a three-month limit operates in several jurisdictions and it was concerned that a longer period, such as six months, would lead to the recognition of stale information. Therefore, it decided to retain the three-month limit.

Exemption from applying the equity method: subsidiary of an investment entity

BC19A In December 2014, the Board amended IFRS 10 to confirm that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 is available to a parent entity that is a subsidiary of an investment entity. The Board also decided to amend paragraph 17 of IAS 28 for the same reasons. Paragraph 17 of IAS 28 uses the same criteria as paragraph 4(a) of IFRS 10 to provide an exemption from applying the equity method for entities that are subsidiaries and that hold interests in associates and joint ventures.

Exemption from applying the equity method: measuring an associate or joint venture at fair value (amendments issued in December 2016)

BC19B When an investment in an associate or joint venture is held by, or is held indirectly through, a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect, in accordance with paragraph 18 of IAS 28, to measure that investment at fair value through profit or loss. The Board received a request to clarify whether the entity is able to choose between applying the equity method or measuring the investment at fair value for each investment, or whether instead the entity applies the same accounting to all of its investments in associates and joint ventures.

BC19C The Board noted that, before it was revised in 2011, IAS 28 *Investments in Associates* permitted a venture capital organisation, or a mutual fund, unit trust and similar entities to elect to measure investments in an associate at fair value through profit or loss separately for each associate. However, after the revision, it had become less clear whether such an election was still available to those entities. The Board noted that it did not consider changing these requirements when revising IAS 28 in 2011, and any lack of clarity that arose as a consequence of the amendments in 2011 was unintentional.

BC19D Accordingly, in *Annual Improvements to IFRS Standards 2014 – 2016 Cycle*, the Board amended paragraph 18 of IAS 28 to clarify that a venture capital organisation, or a mutual fund, unit trust and similar entities may elect, at initial recognition, to measure investments in an associate or joint venture at fair value through profit or loss separately for each associate or joint venture.

BC19E In addition, paragraph 36A of IAS 28 permits an entity that is not an investment entity to retain the fair value measurement applied by its associates and joint ventures (that are investment entities) when applying the equity method. The Board also decided to amend that paragraph to clarify that this choice is available, at initial recognition, for each investment entity associate or joint venture.

BC19F Some respondents to the Board's proposals said that it was not clear whether, in its separate financial statements, a venture capital organisation or a mutual fund, unit trust and similar entities:

- (a) could choose to measure investments in an associate or joint venture at fair value through profit or loss for each associate or joint venture; or
- (b) would be required to measure all such investments at fair value through profit or loss, on the grounds that paragraph 10 of IAS 27 *Separate Financial Statements* requires the same accounting for each category of investments and paragraph 11 of IAS 27 requires investments measured at fair value in accordance with IAS 28 to be measured at fair

value in separate financial statements. If this were to be the case, those respondents note that such an outcome would appear to be inconsistent with the objective of the amendments to IAS 28.

BC19G The Board noted that 'category' is not defined in IFRS Standards, but is used in a number of Standards. For example, IFRS 7 *Financial Instruments: Disclosures* use 'category' to refer to groupings of financial assets and financial liabilities that are measured in different ways—for example, financial assets measured at fair value through profit or loss is one category of financial asset and financial assets measured at amortised cost is another category of financial asset. The Board observed that paragraph 10 of IAS 27 should not be read to mean that, in all circumstances, all investments in associates are one 'category' of investment and all investments in joint ventures are one 'category' of investment. The issue raised by respondents arises only if the requirement in paragraph 10 of IAS 27 were to be interpreted in that way. An entity that elects to measure some associates or joint ventures at fair value through profit or loss in accordance with paragraph 18 of IAS 28 would retain that measurement basis for those associates and joint ventures in its separate financial statements, as required by paragraph 11 of IAS 27. The entity could then choose to measure its remaining associates and joint ventures either at cost, in accordance with IFRS 9 or using the equity method in accordance with paragraph 10 of IAS 27.

BC19H In response to the Board's proposal to apply the amendments retrospectively, some respondents questioned whether the information needed would be available without the use of hindsight. Others suggested providing transition relief for entities that previously interpreted IAS 28 as requiring the same accounting for all investments in associates and joint ventures. They suggested that, when first applying the amendments, such entities should be allowed to elect to measure each existing investment either at fair value through profit or loss or using the equity method.

BC19I The Board decided to retain retrospective application of the amendments because the amendments are expected to affect only a narrow population of entities, and such entities (being venture capital organisation, or mutual funds, unit trusts and similar entities) would typically be expected to have fair value information for their investments for management purposes. In addition, if the costs of applying the amendments retrospectively are considered excessive, an entity can choose not to change any of its previous decisions regarding measurement. This is because retrospective application of a choice of measurement for each associate or joint venture, in effect, means that an entity is not required to reassess its previous decisions. The Board also noted that retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* means that an entity will not use hindsight when first applying the amendments—paragraph 53 of IAS 8 states that hindsight should not be used when applying a new accounting policy to a prior period, either in making assumptions about what management's intentions would have been in a prior period or in estimating the amounts recognised, measured and disclosed in a prior period.

Exemptions from applying the equity method: partial use of fair value measurement of associates

BC20 The Board received a request to clarify whether different measurement bases can be applied to portions of an investment in an associate when part of the investment is not accounted for using the equity method in accordance with paragraph 18 of IAS 28, but it is instead measured at fair value through profit or loss in accordance with IFRS 9. The Board initially deliberated this amendment to IAS 28 as part of the *Improvements to IFRSs* issued in April 2010; however, at its meeting in February 2010 the Board decided to address this issue within the joint ventures project.

BC21 The Board noted that two views exist with respect to measurement. The first view identifies all direct and indirect interests held in the associate either by the parent or through any of its subsidiaries, and then applies IAS 28 to the entire investment in the associate. In accordance with this view, there is only one investment in the associate and it should be accounted for as a single unit. The second view identifies all direct and indirect interests held in an associate, but then allows the use of the measurement exemption to portions of an investment in an associate if the portion is held by a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, regardless of whether those entities have significant influence over their portion of the investment in the

associate. The Board agreed with the second view and therefore amended IAS 28. The Board decided that equivalent guidance on the partial use of fair value for the measurement of investments in joint ventures should not be provided because the Board thought that such events would be unlikely in practice.

- BC22 The Board also discussed whether the partial use of fair value should be allowed only in the case of venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds, that have designated their portion of the investment in the associate at fair value through profit or loss in their own financial statements. The Board noted that several situations might arise in which those entities do not measure their portion of the investment in the associate at fair value through profit or loss. In those situations, however, from the group's perspective, the appropriate determination of the business purpose would lead to the measurement of this portion of the investment in the associate at fair value through profit or loss in the consolidated financial statements. Consequently, the Board decided that an entity should be able to measure a portion of an investment in an associate held by a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, at fair value through profit or loss regardless of whether this portion of the investment is measured at fair value through profit or loss in those entities' financial statements.

Classification as held for sale

- BC23 ED 9 proposed that an entity should account for an interest in a joint venture that is classified as held for sale in accordance with IFRS 5.
- BC24 During its redeliberation of ED 9 the Board noted that the exposure draft *Improvements to IFRSs* published in August 2009 had proposed to amend IFRS 5 so as to require an entity to classify as held for sale its interest in an associate, or in a jointly controlled entity, when it is committed to a sale plan involving loss of significant influence or loss of joint control. Those proposals aimed to clarify that all the interest ('the whole interest') an entity had in an associate or a joint venture had to be classified as held for sale if the entity was committed to a sale plan involving loss of, significant influence over, or joint control of that interest.
- BC25 The Board observed that those proposals were not aligned with the decisions made during the Board's redeliberation of ED 9 to remove all descriptions that associated the loss of joint control and the loss of significant influence with the term 'significant economic event' as introduced in the second phase of the Board's project on business combinations (see paragraphs BC28–BC31).
- BC26 The Board decided that classifying an interest as held for sale should be on the basis of whether the intended disposal meets the criteria for classification as held for sale in accordance with IFRS 5, rather than on whether the entity had lost joint control of, or significant influence over, that interest. As a result, the Board concluded that when the disposal of an interest, or a portion of an interest, in a joint venture or an associate fulfilled the criteria for classification as held for sale in accordance with IFRS 5, an entity should classify the whole interest, or a portion of the interest, as held for sale.
- BC27 The Board decided that, in the case of a partial disposal, an entity should maintain the use of the equity method for the retained interest in the joint venture or associate until the portion classified as held for sale is finally disposed of. The Board reasoned that even if the entity has the intention of selling a portion of an interest in an associate or a joint venture, until it does so it still has significant influence over, or joint control of, that investee. After the disposal, an entity should measure the retained interest in the joint venture or associate in accordance with IFRS 9 or in accordance with IAS 28 if the entity still has significant influence over, or joint control of, the retained interest.

Discontinuing the use of the equity method

- BC28 During its redeliberation of ED 9, the Board reconsidered whether its decision in the second phase of the business combinations project to characterise loss of joint control or loss of significant influence as a significant economic event (ie in the same way that loss of control is characterised as a significant economic event) was appropriate. If it were, the Board thought that the entity should be required to recalibrate the accounting as required by IFRS 10. However, the Board concluded that, although significant, the events are fundamentally different. In the case of loss of control, the cessation of the parent-subsidiary relationship

results in the derecognition of assets and liabilities because the composition of the group changes. If joint control or significant influence is lost the composition of the group is unaffected.

- BC29 The Board also noted that retaining the characterisation of significant economic event in the case of loss of joint control or significant influence when the retained interest is a financial asset is unnecessary. IFRS 9 already requires that in such cases the retained interest (ie a financial asset) must be measured at fair value.
- BC30 In the case of loss of joint control when significant influence is maintained, the Board acknowledged that the investor-investee relationship changes and, consequently, so does the nature of the investment. However, in this instance, both investments (ie the joint venture and the associate) continue to be measured using the equity method. Considering that there is neither a change in the group boundaries nor a change in the measurement requirements, the Board concluded that losing joint control and retaining significant influence is not an event that warrants remeasurement of the retained interest at fair value.
- BC31 Consequently, the Board removed all descriptions that characterise loss of joint control or significant influence as a significant economic event as introduced in the second phase of the Board's project on business combinations.

Incorporation of SIC-13

- BC32 In the joint ventures project, the Board decided to extend the requirements and guidance in IAS 28 for the accounting for 'downstream' and 'upstream' transactions between an entity and its associate to the accounting for transactions between an entity and its joint venture.
- BC33 In ED 9, the Board proposed to incorporate into the standard on joint arrangements the consensus of SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers*. Because the Board relocated all the requirements for the accounting for joint ventures into IAS 28, the Board incorporated the consensus of SIC-13 into IAS 28 and extended it to associates.
- BC34 The Board noted that the consensus of SIC-13 regarding non-monetary contributions made by a venturer³ to a joint venture is consistent with IAS 28, except for the following aspect. SIC-13 established three exceptions for the recognition of gains or losses attributable to the equity interests of the other parties. In response to comments raised by some respondents to ED 9, the Board redeliberated the need to incorporate into IAS 28 the exceptions included in SIC-13 for the recognition by an entity of the portion of a gain or loss attributable to the interests of other unrelated investors in the investee.
- BC35 The Board concluded that only when the transaction lacks commercial substance should there be an exception for the recognition of gains or losses to be carried forward from the consensus of SIC-13 into IAS 28, because the other two exceptions in SIC-13 (ie 'the significant risks and rewards of ownership of the contributed non-monetary asset(s) have not been transferred to the jointly controlled entity' and 'the gain or loss on the non-monetary contribution cannot be measured reliably') either relate to requirements that are not aligned with the principles and requirements of IFRS 11 or relate to a criterion for the recognition of gain or losses (ie 'reliability of measurement') that is already included in the *Conceptual Framework for Financial Reporting*.
- BCZ36 To the extent that the entity also receives monetary or non-monetary assets dissimilar to the assets contributed in addition to equity interests in the investee, the realisation of which is not dependent on the future cash flows of the investee, the earnings process is complete. Accordingly, an entity should recognise in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.
- BC37 Additionally, the Board considered whether the requirements in IAS 31 for recognition of losses when downstream or upstream transactions provide evidence of a reduction in the net

³ IFRS 11 *Joint Arrangements*, issued in May 2011, uses the term 'joint venturers' to designate parties that have joint control of a joint venture.

realisable value or impairment loss of the assets transacted or contributed were still relevant and decided to bring them forward to IAS 28.

Recognition of losses (2003 revision)

- BCZ38 The 2000 version of IAS 28 and SIC-20 *Equity Accounting Method—Recognition of Losses* restricted application of the equity method when, in accounting for the entity's share of losses, the carrying amount of the investment is reduced to zero.
- BCZ39 The Board decided that the base to be reduced to zero should be broader than residual equity interests and should also include other non-equity interests that are in substance part of the net investment in the associate or joint venture, such as long-term receivables. Therefore, the Board decided to withdraw SIC-20.
- BCZ40 The Board also noted that if non-equity investments are not included in the base to be reduced to zero, an entity could restructure its investment to fund the majority in non-equity investments to avoid recognising the losses of the associate or joint venture under the equity method.
- BCZ41 In widening the base against which losses are to be recognised, the Board also clarified the application of the impairment provisions of IAS 39 *Financial Instruments: Recognition and Measurement*⁴ to the financial assets that form part of the net investment.

Impairment losses (2008 amendment)

- BCZ42 In 2008 the Board identified unclear guidance in IAS 28 regarding the extent to which an impairment reversal should be recognised as an adjustment to the carrying amount of an investment in an associate or in a joint venture.
- BCZ43 The Board noted that applying the equity method involves adjusting the entity's share of the impairment loss recognised by the associate or joint venture on assets such as goodwill or property, plant and equipment to take account of the acquisition date fair values of those assets. The Board proposed in the exposure draft *Improvements to International Financial Reporting Standards* published in October 2007 that an additional impairment recognised by the entity, after applying the equity method, should not be allocated to any asset, including goodwill, that forms part of the carrying amount of the investment. Therefore, such an impairment should be reversed in a subsequent period to the extent that the recoverable amount of the investment increases.
- BCZ44 Some respondents to the exposure draft expressed the view that the proposed amendment was not consistent with IAS 39 (regarding reversal of an impairment loss on an available-for-sale equity instrument⁵), or with IAS 36 *Impairment of Assets* (regarding the allocation of an impairment loss to goodwill and any reversal of an impairment loss relating to goodwill).
- BCZ45 In its redeliberations, the Board affirmed its previous decisions but, in response to the comments made, decided to clarify the reasons for the amendments. The Board decided that an entity should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate or joint venture because the investment is the only asset that the entity controls and recognises.
- BCZ46 The Board also decided that any reversal of this impairment loss should be recognised as an adjustment to the investment in the associate or joint venture to the extent that the recoverable amount of the investment increases. This requirement is consistent with IAS 36, which permits the reversal of impairment losses for assets other than goodwill. The Board did not propose to align the requirements for the reversal of an impairment loss with those in IAS 39⁶ relating to equity instruments, because an entity recognises an impairment loss on an investment in an associate or joint venture in accordance with IAS 36, rather than in accordance with IAS 39.

⁴ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that previously were within the scope of IAS 39.

⁵ IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

⁶ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applied to all items that previously were within the scope of IAS 39.

Retaining the fair value measurement applied by an associate or joint venture that is an investment entity

- BC46A In October 2012, the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which required investment entities, as defined in IFRS 10, to measure most investments in subsidiaries at fair value through profit or loss. The amendments did not introduce any new accounting requirements for investments in associates or joint ventures. This is because paragraphs 18–19 of IAS 28 already allowed an investment entity to measure its investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9. A wider range of entities, including venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds, may also elect to measure their investments in associates and joint ventures in the same way.
- BC46B Paragraph 33 of IFRS 10 requires a non-investment entity parent of an investment entity to consolidate all entities that it controls, including those controlled through an investment entity subsidiary. This is consistent with the proposal contained in the Exposure Draft *Investment Entities* (the '*Investment Entities* ED'), which was published in August 2011. Some respondents to the *Investment Entities* ED noted that this seemed inconsistent with paragraphs 18–19 of IAS 28, which allow a wider group of entities than only investment entities to measure their investments in associates and joint ventures at fair value through profit or loss. The Board acknowledged this inconsistency, and explained its reasons for not amending IAS 28 in line with IFRS 10, in paragraph BC283 of IFRS 10.
- BC46C Subsequently, the IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify whether an entity that is not an investment entity should, when applying the equity method of accounting for its investment in an associate or joint venture that is an investment entity, retain the fair value measurement that is applied by that associate or joint venture to its subsidiaries or, instead, 'unwind' that treatment and apply consolidation procedures. Members of the Interpretations Committee had mixed views on the matter and, because of the need to provide clarity before the end of 2014, the matter was passed to the Board.
- BC46D The Board noted that the scope of the amendment in the *Investment Entities* ED was restricted to providing an exception to the consolidation requirements for investment entity parents. This exception reflects the unique business model of an investment entity, for which fair value information is more relevant than consolidation. This unique business model is not applicable to a non-investment entity parent. Consequently, paragraph 33 of IFRS 10 requires a non-investment entity parent of an investment entity to consolidate all entities that it controls, both directly and indirectly through an investment entity. This requires the non-investment entity parent to unwind the fair value through profit or loss measurement used by its investment entity subsidiaries for indirectly held subsidiaries.
- BC46E The Board also noted that paragraphs 35–36 of IAS 28, which require the use of uniform accounting policies, would apply for a non-investment entity investor and its investment entity associates or joint ventures. This would mean that the subsidiaries of those investment entity associates and joint ventures should be consolidated into the financial statements of those associates and joint ventures prior to the equity method being applied. The Board noted that this is conceptually consistent with the requirement in IFRS 10 for a non-investment entity parent to consolidate subsidiaries held through an investment entity subsidiary.
- BC46F However, some Board members raised concerns about the potentially significant practical difficulties or additional costs that may arise for an entity in unwinding the fair value through profit or loss measurement applied by an investment entity associate or joint venture for their interests in subsidiaries. Some Board members noted that the degree of practical difficulty is different depending on whether the investee is an associate or joint venture. In addition, some Board members noted the structuring risks highlighted in paragraph BC280 of IFRS 10 and noted that an investor's ability to achieve different accounting outcomes by holding investments through an investment entity investee is different depending on whether the investee is an associate or a joint venture. Consequently, in the Exposure Draft *Investment*

Entities: Applying the Consolidation Exception (Proposed amendments to IFRS 10 and IAS 28) (the 'Consolidation Exception ED'), which was published in June 2014, the Board proposed to provide relief to non-investment entity investors for their interests in investment entity associates, but not for their interests in investment entity joint ventures.

BC46G The practicality and cost concerns were noted by the majority of respondents to the *Consolidation Exception* ED. However, the majority of respondents disagreed with the proposal to limit the relief to interests in investment entity associates, noting that the practicality and cost issues also applied to interests in joint ventures. In addition, some respondents disagreed with the concerns about the risk of structuring, noting that the difference between significant influence and joint control is much smaller than the difference between control and joint control. Consequently, the Board decided to provide relief to non-investment entity investors in both investment entity associates and joint ventures and to retain the consistency in treatment in applying the equity method to both associates and joint ventures. This relief permits, but does not require, a non-investment entity investor to retain the fair value through profit or loss measurement applied by an investment entity associate or joint venture for their subsidiaries when applying the equity method.

Effective date and transition

BC47 The Board decided to align the effective date for the Standard with the effective date for IFRS 10, IFRS 11, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 27 *Separate Financial Statements*. When making this decision, the Board noted that the five IFRSs all deal with the assessment of, and related accounting and disclosure requirements about, a reporting entity's special relationships with other entities (ie when the reporting entity has control or joint control of, or significant influence over, another entity). As a result, the Board concluded that applying IAS 28 without also applying the other four IFRSs could cause unwarranted confusion.

BC48 The Board usually sets an effective date of between twelve and eighteen months after issuing an IFRS. When deciding the effective date for those IFRSs, the Board considered the following factors:

- (a) the time that many countries require for translation and for introducing the mandatory requirements into law.
- (b) the consolidation project was related to the global financial crisis that started in 2007 and was accelerated by the Board in response to urgent requests from the leaders of the G20, the Financial Stability Board, users of financial statements, regulators and others to improve the accounting and disclosure of an entity's 'off balance sheet' activities.
- (c) the comments received from respondents to the Request for Views *Effective Date and Transition Methods* that was published in October 2010 regarding implementation costs, effective date and transition requirements of the IFRSs to be issued in 2011. Most respondents did not identify the consolidation and joint arrangements IFRSs as having a high impact in terms of the time and resources that their implementation would require. In addition, only a few respondents commented that the effective dates of those IFRSs should be aligned with those of the other IFRSs to be issued in 2011.

BC49 With those factors in mind, the Board decided to require entities to apply the five IFRSs for annual periods beginning on or after 1 January 2013.

BC50 Most respondents to the Request for Views supported early application of the IFRSs to be issued in 2011. Respondents stressed that early application was especially important for first-time adopters in 2011 and 2012. The Board was persuaded by these arguments and decided to permit early application of IAS 28 but only if an entity applies it in conjunction with the other IFRSs (ie IFRS 10, IFRS 11, IFRS 12 and IAS 27 (as amended in 2011)) to avoid a lack of comparability among financial statements, and for the reasons noted in paragraph BC47 that triggered the Board's decision to set the same effective date for all five IFRSs. Even though an entity should apply the five IFRSs at the same time, the Board noted that an

entity should not be prevented from providing any information required by IFRS 12 early if by doing so users gained a better understanding of the entity's relationships with other entities.

- BC50A The Board decided that no specific transition guidance was needed and, therefore, an entity should apply *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28) retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

General

Withdrawal of IAS 28 (2003 revision)

- BC51 IAS 28 *Investments in Associates and Joint Ventures* replaces IAS 28 *Investments in Associates* (as revised in 2003 and amended in 2010). IAS 28 (as amended in 2011) incorporates the accounting for joint ventures and includes some amendments discussed by the Board during its redeliberation of the exposure draft ED 9.

Disclosure

- BC52 IAS 28 does not address the disclosure requirements for entities with joint control of, or significant influence over, an investee. As part of its redeliberation of ED 9 and ED 10 *Consolidated Financial Statements*, the Board identified an opportunity to integrate and make consistent the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities, and to present those requirements in a single IFRS.
- BC53 The Board observed that IAS 27, IAS 28 and IAS 31 contained many similar disclosure requirements. ED 9 had already proposed amendments to the disclosure requirements for joint ventures and associates to align the disclosure requirements for those two types of investments more closely. The Board noted that the majority of respondents agreed with the proposals in ED 9 to align the disclosures for joint ventures with the disclosures in IAS 28 for associates.
- BC54 As a result, the Board combined the disclosure requirements for interest with subsidiaries, joint arrangements, associates and unconsolidated structured entities within a single comprehensive standard, IFRS 12.
- BC55 The Basis for Conclusions accompanying IFRS 12 summarises the Board's considerations in developing that IFRS, including its review of responses to the disclosure proposals in ED 9. Accordingly, IAS 28 does not include disclosure requirements and this Basis for Conclusions does not incorporate the Board's considerations of responses to the proposed disclosure requirements in ED 9.

Summary of main changes from IAS 28 (2003 revision)

BC56 The main changes from the previous version of IAS 28 are as follows:

- (a) The accounting for joint ventures has been incorporated into the Standard.
- (b) The scope exception for venture capital organisations, or mutual funds, unit trusts and similar entities, including investment-linked insurance funds has been eliminated and has been characterised as a measurement exemption from the requirement to measure investments in associates and joint ventures in using the equity method.
- (c) IAS 28 now permits an entity that has an investment in an associate, a portion of which is held indirectly through venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds, to elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with IFRS 9 regardless of whether these entities have significant influence over that portion of the investment.
- (d) IAS 28 requires a portion of an investment in an associate or a joint venture to be classified as held for sale if the disposal of that portion of the interest would fulfil the criteria to be classified as held for sale in accordance with IFRS 5.
- (e) The consensus of SIC-13 has been incorporated into IAS 28. As a result, gains and losses resulting from a contribution of a non-monetary asset to an associate or a joint venture in exchange for an equity interest in an associate or a joint venture are recognised only to the extent of unrelated investors' interests in the associate or joint venture, except when the contribution lacks commercial substance, as that term is described in IAS 16 *Property, Plant and Equipment*.
- (f) The disclosure requirements have been placed in IFRS 12.

Dissenting opinion on amendment issued in May 2008

Dissent of Tatsumi Yamada

- DO1 Mr Yamada voted against one of the amendments to IAS 28 *Investments in Associates* issued in *Improvements to IFRSs* in May 2008.
- DO2 Mr Yamada believes it is inappropriate not to allocate any additional impairment losses to the goodwill and other assets that form part of the carrying amount of the investment in the associate. In his view, because he believes that an investor can identify attributable goodwill when it makes an investment, all impairment losses recognised with respect to the investor's investment in an associate should be allocated to the goodwill and other assets that form part of the carrying amount of the investment.
- DO3 Mr Yamada also believes that all impairment losses allocated to goodwill should not be subsequently reversed. In his view the non-allocation of impairment losses to goodwill as required by the amendment and the subsequent reversal of such impairment losses in substance leads to the recognition of internally generated goodwill. He believes that the amendment to IAS 28 is not consistent with paragraphs 124 and 125 of IAS 36 *Impairment of Assets*, which prohibit the reversal of impairment losses related to goodwill.

Table of Concordance

This table shows how the contents of the superseded version of HKAS 28 (issued in 2004) and the amended version of HKAS 28 in 2011 correspond. Some requirements in the superseded version of HKAS 28 were incorporated into HKFRS 12 *Disclosure of Interests in Other Entities*; this table also shows how those paragraphs correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded HKAS 28 paragraph	Amended HKAS 28 paragraph	HKFRS 12 paragraph	Amended HKAS 27 paragraph
1	2, 18, 19		
2	3, 4		
3			7
4			6
5			8
6	5		
7	6		
8	7		
9	8		
10	9		
11	10		
12	12		
13	17		
14	20		
15	21		
16	11		
17	22		
18	22		
19	22		
19A	23		
20	26		
21	27		
22	28		
23	32		
24	33		
25	34		
26	35		

INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

27	36		
28	37		
29	38		
30	39		
31	40		
32	41		
33	42		
34	43		
35	44		
36			3
37		21–24	
38		21–24	
39		21–24	
40		21–24	
41	45		
41A–41E			
42	47		
43	47		
None	1, 13–16, 24, 25, 29–31, 46		

Amendments to the Basis for Conclusions on IFRS 10 and IAS 28 Investments in Associates and Joint Ventures relating to Sale or Contribution of Assets between an Investor and its Associate or Joint Venture

This appendix contains amendments to the Basis for Conclusions of IAS 28 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of the Basis for Conclusions of IAS 28 and this appendix will be deleted.

Paragraphs BC37A–BC37J and their related heading are added. New text relating to the 2014 Amendments is underlined. New text relating to the 2015 Amendments is underlined and shaded in grey.

Sale or contribution of assets between an investor and its associate or joint venture—amendments to IFRS 10 and IAS 28 (issued in September 2014)

BC37A The IFRS Interpretations Committee received a request to clarify whether a business meets the definition of a ‘non-monetary asset’. The question was asked within the context of identifying whether the requirements of SIC-13¹ and IAS 28 (as revised in 2011) apply when a business is contributed to a jointly controlled entity (as defined in IAS 31²), a joint venture (as defined in IFRS 11) or an associate, in exchange for an equity interest in that jointly controlled entity, joint venture or associate. The business may be contributed either when the jointly controlled entity, joint venture or associate is established or thereafter.

BC37B The Board noted that this matter is related to the issues arising from the acknowledged inconsistency between the requirements in IAS 27 (as revised in 2008) and SIC-13, when accounting for the contribution of a subsidiary to a jointly controlled entity, joint venture or associate (resulting in the loss of control of the subsidiary). In accordance with SIC-13, the amount of the gain or loss recognised resulting from the contribution of a non-monetary asset to a jointly controlled entity in exchange for an equity interest in that jointly controlled entity is restricted to the extent of the interests attributable to the unrelated investors in the jointly controlled entity. However, IAS 27 (as revised in 2008) requires full profit or loss recognition on the loss of control of a subsidiary.

BC37C This inconsistency between IAS 27 (as revised in 2008) and SIC-13 remained after IFRS 10 replaced IAS 27 (as revised in 2008) and SIC-13 was withdrawn. The requirements in IFRS 10 on the accounting for the loss of control of a subsidiary are similar to the requirements in IAS 27 (as revised in 2008). The requirements in SIC-13 are incorporated into paragraphs 28 and 30 of IAS 28 (as amended in 2011) and apply to the sale or contribution of assets between an investor and its associate or joint venture. Because IAS 27 (as revised in 2008) and SIC-13 have been superseded at the time when the amendments become effective, the Board decided to amend only IFRS 10 and IAS 28 (as amended in 2011).

BC37D In dealing with the conflict between the requirements in IFRS 10 and IAS 28 (as amended in 2011), the Board was concerned that the existing requirements could result in the accounting for a transaction being driven by its form rather than by its substance. For example, different accounting might be applied to a transaction involving the same underlying assets depending on whether those assets were:

- (a) transferred in a transaction that is structured as a sale of assets or as a sale of the entity that holds the assets; or
- (b) sold in exchange for cash or contributed in exchange for an equity interest.

¹ SIC-13 has been withdrawn. The requirements in SIC-13 are incorporated into IAS 28 (as amended in 2011).

² IAS 31 was superseded by IFRS 11 Joint Arrangements issued in May 2011.

BC37E The Board concluded that:

- (a) the accounting for the loss of control of a business, as defined in IFRS 3, should be consistent with the conclusions in IFRS 3; and
- (b) a full gain or loss should therefore be recognised on the loss of control of a business, regardless of whether that business is housed in a subsidiary or not.

BC37F Because assets that do not constitute a business were not part of the Business Combinations project, the Board concluded that:

- (a) the current requirements in IAS 28 (as amended in 2011) for the partial gain or loss recognition for transactions between an investor and its associate or joint venture should only apply to the gain or loss resulting from the sale or contribution of assets that do not constitute a business; and
- (b) IFRS 10 should be amended so that a partial gain or loss is recognised in accounting for the loss of control of a subsidiary that does not constitute a business as a result of a transaction between an investor and its associate or joint venture.

BC37G The Board discussed whether all sales and contributions (including the sale or contribution of assets that do not constitute a business) should be consistent with IFRS 3. Although it considered this alternative to be the most robust from a conceptual point of view, it noted that this would require addressing multiple cross-cutting issues. Because of concerns that the cross-cutting issues could not be addressed on a timely basis the conclusions described in paragraphs BC37E–BC37F were considered the best way to address this issue.

BC37H The Board decided that both ‘upstream’ and ‘downstream’ transactions should be affected by the amendments to IFRS 10 and IAS 28 (as amended in 2011). The Board noted that if assets that constitute a business were sold by an associate or a joint venture to the investor (in an upstream transaction), with the result that the investor takes control of that business, the investor would account for this transaction as a business combination in accordance with IFRS 3.

BC37I The Board decided that the amendments to IFRS 10 and IAS 28 (as amended in 2011) should apply prospectively to transactions that occur in annual periods beginning on or after the date that the amendments become effective. The Board observed that the requirements in IAS 27 (as revised in 2008) for the loss of control of a subsidiary (see paragraph 45(c) of IAS 27 as revised in 2008) were applied prospectively. The Board also noted that transactions dealing with the loss of control of a subsidiary or a business between an investor and its associate or joint venture are discrete non-recurring transactions. Consequently, the Board concluded that the benefits of comparative information would not exceed the cost of providing it. The Board also decided to allow entities to early apply the amendments to IFRS 10 and IAS 28 (as amended in 2011).

Deferral of the *Effective Date of Amendments to IFRS 10 and IAS 28* (issued in September 2014)

BC37J In December 2015, the Board decided to defer indefinitely the effective date of the amendments made to IFRS 10 and IAS 28 in September 2014. See paragraphs BC190L–BC190O of the Basis for Conclusions on IFRS 10 *Consolidated Financial Statements*.

Dissenting Opinions

Dissenting Opinions from *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28) as issued in September 2014

- DO1 Mr Kabureck, Ms Lloyd and Mr Ochi voted against the publication of *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). The reasons for their dissents are set out below.

Dissent of Mr Kabureck

- DO2 Mr Kabureck dissents from the amendments to IFRS 10 and IAS 28, which require full gain or loss recognition in the accounting for the loss of control when a parent (investor) sells or contributes a business, as defined in IFRS 3 *Business Combinations*, to an investee (ie an associate or a joint venture) that is accounted for using the equity method.
- DO3 He agrees that the control of a business can be lost regardless of whether the acquirer is a related or an unrelated party. However, he believes that the accounting for the gain or loss should be different if the sale or contribution is to an investee that is accounted for using the equity method. He observes that the investor's interest in the gain or loss will eventually affect the future investee's profit or loss recognised in the investor's profit or loss.

- DO4 His concern can be illustrated by a simple example:

An investor sells a business to a 40 per cent-owned associate accounted for using the equity method. The full gain is CU100.* This gain of CU100 is reflected in the associate's financial statements through the higher value of the net assets acquired. Over time, assuming that no goodwill or indefinite lived intangible assets are involved, the associate's future profits or losses will be lower by CU100 as the assets are consumed and, therefore, the investor's share of the associate's profits or losses will be lower by CU40. Consequently, the net gain of the investor over time is CU60, not CU100.

- DO5 Accordingly, he believes that a more faithful representation of the transaction would be to recognise an immediate gain of CU60 and a deferred gain of CU40, which would be amortised into income, making it consistent with the consumption of the sold assets in the investee's operations. He believes that it would be inappropriate to immediately recognise the full gain knowing that over time there would be lower profits to the extent of the equity interest in the investee.
- DO6 Mr Kabureck observes that his preferred partial gain or loss accounting is consistent with the accounting for the sales of assets that do not constitute a business, as described in paragraphs BC190F of IFRS 10 and BC37F of IAS 28. Whether or not the assets sold or contributed do, or do not, constitute a business, seems to him to provide little rationale for different gain or loss treatment. He further observes that the line between what constitutes a business versus a collection of assets is frequently unclear, often based on judgement and represents an interpretation challenge in practice. He disagrees with introducing another accounting difference that is dependent on the interpretation of the definition of a business.

* In this document, monetary items are denominated by 'currency units' (CU).

Dissent of Ms Lloyd and Mr Ochi

- DO7 Ms Lloyd and Mr Ochi agree that the sale of assets that constitute a business and the sale of assets that do not constitute a business should be treated differently for the reasons given in paragraphs BC190G of IFRS 10 and BC37G of IAS 28. However, they also believe that the accounting result should not differ depending on whether assets that do not constitute a business are transferred in a transaction that is structured as a sale of assets or as a sale of the entity that holds those assets. Ms Lloyd and Mr Ochi believe that these amendments do not achieve that result.
- DO8 The stated objective of these amendments is to address the conflict between the requirements of IFRS 10 and IAS 28. Prior to these amendments, IFRS 10 required full gain or loss recognition on the loss of control of a subsidiary, whereas IAS 28 restricted the gain or loss resulting from the sale or contribution of assets to an associate or a joint venture to the extent of the interests that were attributable to unrelated investors in that associate or joint venture (downstream transactions).
- DO9 As a result of these amendments, there will continue to be a full gain or loss recognition on the loss of control of a subsidiary that constitutes a business under IFRS 10, as well as a full gain or loss recognition resulting from the sale or contribution of assets that constitute a business between an investor and its associate or joint venture under IAS 28. The gain or loss recognised on the sale of the business will be the same whether it is structured as a sale of assets that constitute a business or as a sale of the entity that contains a business. As stated above, Ms Lloyd and Mr Ochi agree with this result.
- DO10 Even after the amendments, IAS 28 will continue to restrict the gain or loss resulting from the sale or contribution of assets that do not constitute a business to an associate or a joint venture to the extent of the interests that are attributable to unrelated investors in that associate or joint venture. However, as a result of these amendments, under IFRS 10, when an entity sells an interest in a subsidiary that does not contain a business to an associate or a joint venture and as a result loses control of that subsidiary but retains joint control or significant influence over it, the gain or loss recognised is also limited to the unrelated investor's interests in the associate or joint venture to which the interest in the subsidiary was sold. In addition, the entity will remeasure its retained interest in the former subsidiary to fair value at the date it loses control, even though that retained interest is not in an entity that constitutes a business. Ms Lloyd and Mr Ochi acknowledge that under the amendments, recognition of the gain or loss on remeasurement will be limited to the unrelated investor's interests in the associate or joint venture to which the interest in the subsidiary was sold. However, because Ms Lloyd and Mr Ochi believe the sale of a subsidiary that does not constitute a business, and the sale of the assets held in that subsidiary, is substantially the same transaction, they do not find any justification for the recognition of any additional gain on the remeasurement of the retained portion.
- DO11 Furthermore, Ms Lloyd and Mr Ochi note that if the retained interest in the former subsidiary is an investment accounted for in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*, the amount of gain or loss recognised on remeasurement will not be restricted. A full gain or loss will be recognised on remeasurement of the retained interest even though that interest is not in an entity that constitutes a business. As a result of the remeasurement of the retained interest in the former subsidiary, the amount of gain or loss recognised in a transaction involving the same underlying assets will still be different depending on whether those assets are transferred in a transaction that is structured as a sale of assets or as a sale of the entity that holds the assets. Ms Lloyd and Mr Ochi disagree with this result. They believe that the remeasurement of a retained interest in a former subsidiary to fair value when control is lost is a fundamental principle of IFRS 10. They also believe that accounting for equity interests that do not represent control, joint control or significant

influence at fair value is a fundamental principle of IFRS 9 and IAS 39. Ms Lloyd and Mr Ochi do not believe that these principles can be reconciled in a limited-scope amendment to the treatment in IAS 28 of downstream transactions that involve the sale of assets that do not constitute a business.

- DO12 Consequently, Ms Lloyd and Mr Ochi dissent from these amendments because they do not fully address the concerns of the Board and the IFRS Interpretations Committee as set out in paragraphs BC190D of IFRS 10 and BC37D of IAS 28.

Amendments to the Basis for Conclusions on IAS 28 *Long-term Interests in Associates and Joint Ventures*

This appendix contains amendments to the Basis for Conclusions of IAS 28 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of the Basis for Conclusions of IAS 28 and this appendix will be deleted.

Paragraphs BC16A–BC16L and their related headings are added.

Equity method

Long-term interests in associates and joint ventures

- BC16A The Board received a submission relating to long-term interests in an associate or joint venture that, in substance, form part of the net investment in the associate or joint venture (long-term interests). The submission asked whether long-term interests are within the scope of IFRS 9 and, if so, whether the impairment requirements in IFRS 9 apply to such long-term interests.
- BC16B In considering the submission, the Board and the IFRS Interpretations Committee discussed the accounting for long-term interests applying the requirements in IFRS 9 and IAS 28, without reconsidering those requirements. The submission was narrowly and clearly defined, and both bodies concluded they could respond to the submission most efficiently by considering only the submission received. Any reconsideration of the accounting for long-term interests could not be undertaken as a narrow-scope project and would be likely to involve reconsideration of the equity method, a topic included in the Board's pipeline of future research projects. Consequently, the Board limited the amendments to clarifying its intentions when it issued the requirements in IFRS 9 and IAS 28.
- BC16C The Board concluded that with respect to interests in an associate or joint venture, paragraph 2.1(a) of IFRS 9 excludes from the scope of IFRS 9 only interests to which the equity method is applied. Accordingly, the scope exclusion in that paragraph does not include long-term interests (as described in paragraph 38 of IAS 28). In reaching this conclusion, the Board noted that IAS 28 mentions long-term interests and the net investment, which includes long-term interests, only in the context of recognising losses of an associate or joint venture and impairment of the net investment in the associate or joint venture. IAS 28 does not specify requirements for other aspects of recognising or measuring long-term interests. Thus, long-term interests are not accounted for in accordance with IAS 28, as envisaged in paragraph 2.1(a) of IFRS 9. The Board also noted that paragraph 14 of IAS 28 states that 'IFRS 9 *Financial Instruments* does not apply to interests in associates and joint ventures that are accounted for using the equity method'.
- BC16D The Board clarified in paragraph 14A of IAS 28 that IFRS 9, including its impairment requirements, applies to long-term interests. The Board also deleted paragraph 41 as part of the amendments. That paragraph had merely reiterated requirements in IFRS 9, and had created confusion about the accounting for long-term interests.
- BC16E Respondents to the Board's Exposure Draft on long-term interests suggested that it further clarify how the requirements in IAS 28 and IFRS 9 apply to long-term interests because, in the respondents' view, the benefits of the amendments would be limited without such clarifications. Respondents also suggested including an illustrative example.

- BC16F In response, the Board clarified that an entity applies IFRS 9, rather than IAS 28, in accounting for long-term interests. Thus, when applying IFRS 9, it does not take account of any losses of the associate or joint venture, or any impairment losses on the net investment, recognised as adjustments to the net investment in the associate or joint venture applying IAS 28.
- BC16G In addition, at the same time it issued the amendments, the Board published an example that illustrates how entities apply the requirements in IAS 28 and IFRS 9 with respect to long-term interests.

Effective date and transition

- BC16H The Board proposed to align the effective date of the amendments with the effective date of IFRS 9—annual reporting periods beginning on or after 1 January 2018. Some respondents said an effective date of 1 January 2018 would not allow sufficient time to implement the amendments. In particular, the respondents mentioned entities in jurisdictions that have a translation or endorsement process for IFRS Standards.
- BC16I In the light of these concerns, the Board set an effective date of annual reporting periods beginning on or after 1 January 2019, with earlier application permitted. The Board noted that if an entity elects to apply the amendments when it first applies IFRS 9, then it would benefit from applying the transition requirements in IFRS 9 to long-term interests.
- BC16J Considering the effective date of 1 January 2019 and the requirement to apply the amendments retrospectively, the Board also provided transition requirements similar to those in IFRS 9 for entities that apply the amendments after they first apply IFRS 9. This is because retrospective application may not have been possible without the use of hindsight. When the Board developed IFRS 9, it provided transition requirements for scenarios in which it would have been impracticable for an entity to apply particular requirements retrospectively. Consequently, the Board provided similar transition requirements in the amendments to IAS 28 for long-term interests because the effect of the amendments might be that an entity applies IFRS 9 for the first time to those interests. Accordingly, for example, such an entity would assess its business model for such long-term interests based on the facts and circumstances that exist on the date it first applies the amendments (for example, 1 January 2019 for an entity applying the amendments from that date).
- BC16K The Board noted that at the date of initial application of the amendments an entity would be able to use these transition requirements only for long-term interests and not for other financial instruments to which the entity has already applied IFRS 9. Accordingly, for example, an entity is not permitted (or required) to reconsider any of its fair value option elections for financial instruments to which the entity has already applied IFRS 9.
- BC16L The Board also decided to provide relief from restating prior periods for entities electing, in accordance with IFRS 4 *Insurance Contracts*, to apply the temporary exemption from IFRS 9. The Board observed that the effect of the amendments for such entities might be that they apply IAS 39 for the first time to long-term interests.

Dissenting opinion

Dissent of Mr Takatsugu Ochi from *Long-term Interests in Associates and Joint Ventures* (Amendments to IAS 28)

- DO1 Mr Ochi voted against the publication of *Long-term Interests in Associates and Joint Ventures* (Amendments to IAS 28). The reasons for his dissent are set out below.
- DO2 Mr Ochi believes that interests in an associate or joint venture should be subject to either the requirements in IFRS 9 or the requirements in IAS 28, but not both. Accordingly, he disagrees with amending IAS 28 without also specifying the types of interests in an associate or joint venture that an entity accounts for using the equity method, and the types of interests in such entities that an entity accounts for applying IFRS 9.
- DO3 Mr Ochi notes that the amendments would result in 'dual application' of accounting requirements to the same asset, which he thinks is contrary to basic principles of accounting standards. He believes that such dual application of accounting requirements might result in double counting and, therefore, could undermine the quality of financial statements.

Illustrative Example—Long-term Interests in Associates and Joint Ventures

This example portrays a hypothetical situation illustrating how an entity (investor) accounts for long-term interests that, in substance, form part of the entity's net investment in an associate (long-term interests) applying IFRS 9 and IAS 28 based on the assumptions presented. The entity applies IFRS 9 in accounting for long-term interests. The entity applies IAS 28 to its net investment in the associate, which includes long-term interests. The analysis in this example is not intended to represent the only manner in which the requirements in IAS 28 could be applied.

Assumptions

The investor has the following three types of interests in the associate:

- (a) O Shares—ordinary shares representing a 40% ownership interest to which the investor applies the equity method. This interest is the least senior of the three interests, based on their relative priority in liquidation.
- (b) P Shares—non-cumulative preference shares that form part of the net investment in the associate and that the investor measures at fair value through profit or loss applying IFRS 9.
- (c) LT Loan—a long-term loan that forms part of the net investment in the associate and that the investor measures at amortised cost applying IFRS 9, with a stated interest rate and an effective interest rate of 5% a year. The associate makes interest-only payments to the investor each year. The LT Loan is the most senior of the three interests.

The LT Loan is not an originated credit-impaired loan. Throughout the years illustrated, there has not been any objective evidence that the net investment in the associate is impaired applying IAS 28, nor does the LT Loan become credit-impaired applying IFRS 9.

The associate does not have any outstanding cumulative preference shares classified as equity, as described in paragraph 37 of IAS 28. Throughout the years illustrated, the associate neither declares nor pays dividends on O Shares or P Shares.

The investor has not incurred any legal or constructive obligations, nor made payments on behalf of the associate, as described in paragraph 39 of IAS 28. Accordingly, the investor does not recognise its share of the associate's losses once the carrying amount of its net investment in the associate is reduced to zero.

The amount of the investor's initial investment in O Shares is CU200¹ in P Shares is CU100 and in the LT Loan is CU100. On acquisition of the investment, the cost of the investment equals the investor's share of the net fair value of the associate's identifiable assets and liabilities.

This table summarises the carrying amount at the end of each year for P Shares and the LT Loan applying IFRS 9 but before applying IAS 28, and the associate's profit (loss) for each year. The amounts for the LT Loan are shown net of the loss allowance.

¹ In this Illustrative Example, currency amounts are denominated in currency units (CU).

At the end of	P Shares applying IFRS 9 (fair value)	LT Loan applying IFRS 9 (amortised cost)	Profit (Loss) of the associate
Year 1	CU110	CU90	CU50
Year 2	CU90	CU70	CU(200)
Year 3	CU50	CU50	CU(500)
Year 4	CU40	CU50	CU(150)
Year 5	CU60	CU60	–
Year 6	CU80	CU70	CU500
Year 7	CU110	CU90	CU500

Analysis

Year 1

The investor recognises the following in Year 1:

Investments in the associate:

DR. O Shares	CU200	
DR. P Shares	CU100	
DR. LT Loan	CU100	
CR. Cash		CU400

To recognise the initial investment in the associate

DR. P Shares	CU10	
CR. Profit or loss		CU10

To recognise the change in fair value (CU110 – CU100)

DR. Profit or loss	CU10	
CR. Loss allowance (LT Loan)		CU10

To recognise an increase in the loss allowance (CU90 – CU100)

DR. O Shares	CU20	
CR. Profit or loss		CU20

To recognise the investor's share of the associate's profit (CU50 × 40%)

At the end of Year 1, the carrying amount of O Shares is CU220, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

Year 2

The investor recognises the following in Year 2:

DR. Profit or loss	CU20	
CR. P Shares		CU20

To recognise the change in fair value (CU90 – CU110)

DR. Profit or loss	CU20	
CR. Loss allowance (LT Loan)		CU20

To recognise an increase in the loss allowance (CU70 – CU90)

DR. Profit or loss	CU80	
CR. O Shares		CU80

To recognise the investor's share of the associate's loss (CU200 × 40%)

At the end of Year 2, the carrying amount of O Shares is CU140, P Shares is CU90 and the LT Loan (net of loss allowance) is CU70.

Year 3

Applying paragraph 14A of IAS 28, the investor applies IFRS 9 to P Shares and the LT Loan before it applies paragraph 38 of IAS 28. Accordingly, the investor recognises the following in Year 3:

DR. Profit or loss	CU40	
CR. P Shares		CU40

To recognise the change in fair value (CU50 – CU90)

DR. Profit or loss	CU20	
CR. Loss allowance (LT Loan)		CU20

To recognise an increase in the loss allowance (CU50 – CU70)

DR. Profit or loss	CU200	
CR. O Shares		CU140
CR. P Shares		CU50
CR. LT Loan		CU10

To recognise the investor's share of the associate's loss in reverse order of seniority as specified in paragraph 38 of IAS 28 (CU500 × 40%)

At the end of Year 3, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is CU40.

Year 4

Applying IFRS 9 to its interests in the associate, the investor recognises the following in Year 4:

DR. Profit or loss	CU10	
CR. P Shares		CU10

To recognise the change in fair value (CU40 – CU50)

Recognition of the change in fair value of CU10 in Year 4 results in the carrying amount of P Shares being negative CU10. Consequently, the investor recognises the following to reverse a portion of the associate's losses previously allocated to P Shares:

DR. P Shares	CU10	
CR. Profit or loss		CU10

To reverse a portion of the associate's losses previously allocated to P Shares

Applying paragraph 38 of IAS 28, the investor limits the recognition of the associate's losses to CU40 because the carrying amount of its net investment in the associate is then zero. Accordingly, the investor recognises the following:

DR. Profit or loss	CU40	
CR. LT Loan		CU40

To recognise the investor's share of the associate's loss

At the end of Year 4, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero. There is also an unrecognised share of the associate's losses of CU30 (the investor's share of the associate's cumulative losses of CU340 – CU320 losses recognised cumulatively + CU10 losses reversed).

Year 5

Applying IFRS 9 to its interests in the associate, the investor recognises the following in Year 5:

DR. P Shares	CU20	
CR. Profit or loss		CU20

To recognise the change in fair value (CU60 – CU40)

DR. Loss allowance (LT Loan)	CU10	
CR. Profit or loss		CU10

To recognise a decrease in the loss allowance (CU60 – CU50)

After applying IFRS 9 to P Shares and the LT Loan, these interests have a positive carrying amount. Consequently, the investor allocates the previously unrecognised share of the associate's losses of CU30 to these interests.

DR. Profit or loss	CU30	

CR. P Shares	CU20

CR. LT Loan	CU10

To recognise the previously unrecognised share of the associate's losses

At the end of Year 5, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero.

Year 6

Applying IFRS 9 to its interests in the associate, the investor recognises the following in Year 6:

DR. P Shares	CU20

CR. Profit or loss	CU20

To recognise the change in fair value (CU80 – CU60)

DR. Loss allowance (LT Loan)	CU10

CR. Profit or loss	CU10

To recognise a decrease in the loss allowance (CU70 – CU60)

The investor allocates the associate's profit to each interest in the order of seniority. The investor limits the amount of the associate's profit it allocates to P Shares and the LT Loan to the amount of equity method losses previously allocated to those interests, which in this example is CU60 for both interests.

DR. O Shares	CU80

DR. P Shares	CU60

DR. LT Loan	CU60

CR. Profit or loss	CU200

To recognise the investor's share of the associate's profit (CU500 × 40%)

At the end of Year 6, the carrying amount of O Shares is CU80, P Shares is CU80 and the LT Loan (net of loss allowance) is CU70.

Year 7

The investor recognises the following in Year 7:

DR. P Shares	CU30	
CR. Profit or loss		CU30

To recognise the change in fair value (CU110 – CU80)

DR. Loss allowance (LT Loan)	CU20	
CR. Profit or loss		CU20

To recognise a decrease in the loss allowance (CU90 – CU70)

DR. O Shares	CU200	
CR. Profit or loss		CU200

To recognise the investor's share of the associate's profit (CU500 × 40%)

At the end of Year 7, the carrying amount of O Shares is CU280, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

Years 1–7

When recognising interest revenue on the LT Loan in each year, the investor does not take account of any adjustments to the carrying amount of the LT Loan that arose from applying IAS 28 (paragraph 14A of IAS 28). Accordingly, the investor recognises the following in each year:

DR. Cash	CU5	
CR. Profit or loss		CU5

To recognise interest revenue on LT Loan based on the effective interest rate of 5%

Summary of amounts recognised in profit or loss

This table summarises the amounts recognised in the investor's profit or loss.

Items recognised	Impairment (losses), including reversals, applying IFRS 9	Gains (losses) of P Shares applying IFRS 9	Share of profit (loss) of the associate recognised applying the equity method	Interest revenue applying IFRS 9
During				
Year 1	CU(10)	CU10	CU20	CU5
Year 2	CU(20)	CU(20)	CU(80)	CU5
Year 3	CU(20)	CU(40)	CU(200)	CU5
Year 4	–	CU(10)	CU(30)	CU5
Year 5	CU10	CU20	CU(30)	CU5
Year 6	CU10	CU20	CU200	CU5
Year 7	CU20	CU30	CU200	CU5

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 32

Financial Instruments: Presentation



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Introduction

Reasons for issuing HKAS 32

- IN1 Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* (HKAS 32)* should be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for annual periods beginning before 1 January 2005 unless it also applies HKAS 39. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.
- IN2 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 32 is to maintain international convergence with the International Accounting Standards Board (IASB).
- IN3 [Deleted]

The main features

- IN4 The main features of HKAS 32 are described below.

Scope

- IN5 The scope of HKAS 32 has, where appropriate, been conformed to the scope of HKAS 39.
- IN5A In December 2013 the scope of HKAS 32 was conformed to the scope of HKAS 39[#] as amended in December 2013 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in HKAS 39).

Principle

- IN6 In summary, when an issuer determines whether a financial instrument is a financial liability or an equity instrument, the instrument is an equity instrument if, and only if, both conditions (a) and (b) are met.
- (a) The instrument includes no contractual obligation:
- (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
- (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) a derivative that will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

* In September 2005 the HKICPA amended HKAS 32 by relocating all disclosures relating to financial instruments to HKFRS 7 *Financial Instruments: Disclosures*. In June 2008 the HKICPA amended HKAS 32 by requiring some puttable financial instruments and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.

[#] In September 2014 the HKICPA relocated the scope of HKAS 39 to HKFRS 9.

- IN7 In addition, when an issuer has an obligation to purchase its own shares for cash or another financial asset, there is a liability for the amount that the issuer is obliged to pay.
- IN8 The definitions of a financial asset and a financial liability, and the description of an equity instrument, are amended consistently with this principle.

Classification of contracts settled in an entity's own equity instruments

- IN9 The classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments has been clarified consistently with the principle in paragraph IN6 above. In particular, when an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability.

Puttable instruments

- IN10 HKAS 32 incorporates a guidance that a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability of the issuer. In response to comments received on the Exposure Draft, the Standard provides additional guidance and illustrative examples for entities that, because of this requirement, have no equity or whose share capital is not equity as defined in HKAS 32.

Contingent settlement provisions

- IN11 HKAS 32 incorporates a conclusion that a financial instrument is a financial liability when the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder. Contingent settlement provisions are ignored when they apply only in the event of liquidation of the issuer or are not genuine.

Settlement options

- IN12 Under HKAS 32, a derivative financial instrument is a financial asset or a financial liability when it gives one of the parties to it a choice of how it is settled unless all of the settlement alternatives would result in it being an equity instrument.

Measurement of the components of a compound financial instrument on initial recognition

- IN13 The revisions eliminate the option previously in HKAS 32 to measure the liability component of a compound financial instrument on initial recognition either as a residual amount after separating the equity component, or by using a relative-fair-value method. Thus, Any asset and liability components are separated first and the residual is the amount of any equity component. These requirements for separating the liability and equity components of a compound financial instrument are conformed to both the definition of an equity instrument as a residual and the measurement requirements in HKFRS 9 HKAS 39.

Treasury shares

- IN14 HKAS 32 incorporates a conclusion that the acquisition or subsequent resale by an entity of its own equity instruments does not result in a gain or loss for the entity. Rather it represents a transfer between those holders of equity instruments who have given up their equity interest and those who continue to hold an equity instrument.

Hong Kong Accounting Standard 32

Financial Instruments: Presentation

Objective

- 1 [Deleted]
- 2 The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.
- 3 The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in HKFRS 9 *Financial Instruments* ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~, and for disclosing information about them in HKFRS 7 *Financial Instruments: Disclosures*.

Scope

- 4 This Standard shall be applied by all entities to all types of financial instruments except:
 - (a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with HKFRS 10 *Consolidated Financial Statements*, HKAS 27 *Separate Financial Statements* or HKAS 28 *Investments in Associates and Joint Ventures*. However, in some cases, HKFRS 10, HKAS 27 or HKAS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture using HKFRS 9 ~~HKAS 39~~; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.
 - (b) employers' rights and obligations under employee benefit plans, to which HKAS 19 *Employee Benefits* applies.
 - (c) [deleted]
 - (d) insurance contracts as defined in HKFRS 4 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if HKFRS 9 ~~HKAS 39~~ requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies HKFRS 9 ~~HKAS 39~~ in recognising and measuring the contracts, but shall apply HKFRS 4 if the issuer elects, in accordance with paragraph 4(d) of HKFRS 4, to apply HKFRS 4 in recognising and measuring them.
 - (e) financial instruments that are within the scope of HKFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see HKFRS 9 ~~HKAS 39~~).

- (f) **financial instruments, contracts and obligations under share-based payment transactions to which HKFRS 2 *Share-based Payment* applies, except for**
- (i) **contracts within the scope of paragraphs 8–10 of this Standard, to which this Standard applies,**
 - (ii) **paragraphs 33 and 34 of this Standard, which shall be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements.**

5-7 [Deleted]

8 This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 2.5 of HKFRS 9 *Financial Instruments*.

9 There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

- (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
- (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
- (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 8 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this Standard.

10 A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 9(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

- (ii) 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. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13 *Fair Value Measurement*.)

A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

- 12 The following terms are defined in Appendix A of HKFRS 9 or paragraph 9 of HKAS 39 *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in HKAS 39 and HKFRS 9.

- amortised cost of a financial asset or financial liability
- ~~available for sale financial assets~~
- derecognition
- derivative
- effective interest method
- ~~financial asset or financial liability at fair value through profit or loss~~
- financial guarantee contract
- financial liability at fair value through profit or loss
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held for trading~~held-to-maturity investments~~
- ~~loans and receivables~~
- regular way purchase or sale
- transaction costs.

- 13 In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

- 14 In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

- 23 With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity. Subsequently, the financial liability is measured in accordance with HKFRS 9~~HKAS 39~~. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).
- 24 A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold.

Contingent settlement provisions

- 25 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:
- (a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
 - (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
 - (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.

Settlement options

- 26 **When a derivative financial instrument gives one party a choice over how it is settled (e.g. the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.**
- 27 An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity's own equity instruments are within the scope of this Standard because they can be settled either by delivery of the

non-financial item or net in cash or another financial instrument (see paragraphs 8-10). Such contracts are financial assets or financial liabilities and not equity instruments.

Compound financial instruments (see also paragraphs AG30-AG35 and Illustrative Examples 9-12)

- 28 **The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.**
- 29 An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately in its statement of financial position.
- 30 Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.
- 31 ~~HKFRS 9~~ ~~HKAS 39~~ deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.
- 32 Under the approach described in paragraph 31, the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

- 40 Dividends classified as an expense may be presented in the statement(s) of profit or loss and other comprehensive income either with interest on other liabilities or as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of HKAS 1 and HKFRS 7. In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement(s) of profit or loss and other comprehensive income. Disclosures of the tax effects are made in accordance with HKAS 12.
- 41 Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 18(b)). Under HKAS 1 the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of comprehensive income when it is relevant in explaining the entity's performance.

Offsetting a financial asset and a financial liability (see also paragraphs AG38A-AG38F and AG39)

- 42 **A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:**
- (a) currently has a legally enforceable right to set off the recognised amounts; and**
 - (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.**

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see HKFRS 9-HKAS 39, paragraph 3.2.2236).

- 43 This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity. An entity shall disclose the information required in paragraphs 13B-13E of HKFRS 7 for recognised financial instruments that are within the scope of paragraph 13A of HKFRS 7.
- 44 Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the statement of financial position but also may result in recognition of a gain or loss.
- 45 A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.

- 50 An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 42 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with paragraph 36 of HKFRS 7.

Disclosure

51-95 [Deleted]

Effective date and transition

- 96 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for annual periods beginning before 1 January 2005 unless it also applies HKAS 39. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.
- 96A *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1), issued in June 2008, required financial instruments that contain all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D to be classified as an equity instrument, amended paragraphs 11, 16, 17–19, 22, 23, 25, AG13, AG14 and AG27, and inserted paragraphs 16A–16F, 22A, 96B, 96C, 97C, AG14A–AG14J and AG29A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the changes for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 1, HKAS 39, HKFRS 7 and HK(IFRIC)-Int 2 at the same time.
- 96B *Puttable Financial Instruments and Obligations Arising on Liquidation* introduced a limited scope exception; therefore, an entity shall not apply the exception by analogy.
- 96C The classification of instruments under this exception shall be restricted to the accounting for such an instrument under HKAS 1, HKAS 32, HKAS 39, ~~and~~ HKFRS 7 and HKFRS 9. The instrument shall not be considered an equity instrument under other guidance, for example HKFRS 2.
- 97 This Standard shall be applied retrospectively, and accounting policies adopted in respect of each period presented shall be disclosed. When comparative information for prior periods is not available when this Standard is first applied, such information need not be presented, but an entity shall disclose that fact.
- 97A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 40. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

- 97B HKFRS 3 *Business Combinations* (as revised in 2008) deleted paragraph 4(c). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period. However, the amendment does not apply to contingent consideration that arose from a business combination for which the acquisition date preceded the application of HKFRS 3 (revised 2008). Instead, an entity shall account for such consideration in accordance with paragraphs 65A–65E of HKFRS 3 (as amended in 2010).
- 97C When applying the amendments described in paragraph 96A, an entity is required to split a compound financial instrument with an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation into separate liability and equity components. If the liability component is no longer outstanding, a retrospective application of those amendments to HKAS 32 would involve separating two components of equity. The first component would be in retained earnings and represent the cumulative interest accreted on the liability component. The other component would represent the original equity component. Therefore, an entity need not separate these two components if the liability component is no longer outstanding at the date of application of the amendments.
- 97D Paragraph 4 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact and apply for that earlier period the amendments to paragraph 3 of HKFRS 7, paragraph 1 of HKAS 28 and paragraph 1 of HKAS 31 issued in October 2008. An entity is permitted to apply the amendment prospectively.
- 97E Paragraphs 11 and 16 were amended by *Classification of Rights Issues* issued in October 2009. An entity shall apply that amendment for annual periods beginning on or after 1 February 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.
- 97F ~~[Deleted] [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 97G Paragraph 97B was amended by *Improvements to HKFRSs* issued in May 2010. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted.
- 97H ~~[Deleted] [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 97I HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 4(a) and AG29. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 97J HKFRS 13, issued in June 2011, amended the definition of fair value in paragraph 11 and amended paragraphs 23 and AG31. An entity shall apply those amendments when it applies HKFRS 13.
- 97K *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 40. An entity shall apply that amendment when it applies HKAS 1 as amended in July 2011.
- 97L *Offsetting Financial Assets and Financial Liabilities* (Amendments to HKAS 32), issued in December 2011, deleted paragraph AG38 and added paragraphs AG38A–AG38F. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. An entity shall apply those amendments retrospectively. Earlier application is permitted. If an entity applies those amendments from an earlier date, it shall disclose that fact and shall also make the disclosures required by *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to HKFRS 7) issued in December 2011.

- 97M *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to HKFRS 7), issued in December 2011, amended paragraph 43 by requiring an entity to disclose the information required in paragraphs 13B–13E of HKFRS 7 for recognised financial assets that are within the scope of paragraph 13A of HKFRS 7. An entity shall apply that amendment for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. An entity shall provide the disclosures required by this amendment retrospectively.
- 97N *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraphs 35, 37 and 39 and added paragraph 35A. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 97O *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, amended paragraph 4. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies that amendment earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 97P ~~[Deleted]~~
- 97Q HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph AG21. An entity shall apply that amendment when it applies HKFRS 15.
- 97R HKFRS 9, as issued in September 2014, amended paragraphs 3, 4, 8, 12, 23, 31, 42, 96C, AG2 and AG30 and deleted paragraphs 97F, 97H and 97P. An entity shall apply those amendments when it applies HKFRS 9.

Withdrawal of Other Pronouncements

- 98 This Standard, together with HKAS 39 *Financial Instruments: Recognition and Measurement*, supersede SSAP 24 *Accounting for Investments in Securities* issued in 1999.*

* In September 2005 the Institute relocated all disclosures relating to financial instruments to HKFRS 7 *Financial Instruments: Disclosures*.

Appendix

Application Guidance

HKAS 32 *Financial Instruments: Presentation*

This appendix is an integral part of the Standard.

- AG1 This Application Guidance explains the application of particular aspects of the Standard.
- AG2 The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in HKFRS 9 ~~HKAS 39~~.

Definitions (paragraphs 11-14)

Financial assets and financial liabilities

- AG3 Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.
- AG4 Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:
- (a) trade accounts receivable and payable;
 - (b) notes receivable and payable;
 - (c) loans receivable and payable; and
 - (d) bonds receivable and payable.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

- AG5 Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.
- AG6 'Perpetual' debt instruments (such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial

- AG21 Except as required by HKFRS 15 *Revenue from Contracts with Customer*, A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.
- AG22 Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.
- AG23 The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.
- AG24 [Deleted]

Presentation

Liabilities and equity (paragraphs 15-27)

No contractual obligation to deliver cash or another financial asset (paragraphs 17-20)

- AG25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

Compound financial instruments (paragraphs 28-32)

- AG30 Paragraph 28 applies only to issuers of non-derivative compound financial instruments. Paragraph 28 does not deal with compound financial instruments from the perspective of holders. HKFRS 9 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective. ~~HKAS 39 deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.~~
- AG31 A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivative features. Paragraph 28 requires the issuer of such a financial instrument to present the liability component and the equity component separately in the statement of financial position, as follows:
- (a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.
 - (b) The equity instrument is an embedded option to convert the liability into equity of the issuer. This option has value on initial recognition even when it is out of the money.
- AG32 On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.
- AG33 When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 28-32.
- AG34 Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:
- (a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and
 - (b) the amount of consideration relating to the equity component is recognised in equity.
- AG35 An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

Effective for annual periods
beginning on or after 1 January 2005

*Basis for Conclusions on
Hong Kong Accounting Standard 32*

Financial Instruments: Presentation



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Basis for Conclusions on IAS 32 *Financial Instruments: Presentation*

This Basis for Conclusions accompanies, but is not part of, IAS 32.

~~References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.~~

- BC1 This Basis for Conclusions summarises the International Accounting Standard Board's considerations in reaching its conclusions on revising IAS 32 *Financial Instruments: Disclosure and Presentation** in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*.# The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies, and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of proposed amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, with a comment deadline of 14 October 2002. The Board received over 170 comment letters on the Exposure Draft.
- BC3 Because the Board did not reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and IAS 39, this Basis for Conclusions does not discuss requirements in IAS 32 that the Board has not reconsidered.
- BC3A In July 2006 the Board published an exposure draft of proposed amendments to IAS 32 relating to the classification of puttable instruments and instruments with obligations arising on liquidation. The Board subsequently confirmed the proposals and in 2008 issued an amendment that now forms part of IAS 32. A summary of the Board's considerations and reasons for its conclusions is in paragraphs BC50–BC74.

Scope

- BC3B In November 2013 the Board amended the scope of IAS 32 so that it conformed to the scope of IAS 39 as amended in November 2013 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).
- BC3C IFRS 9 replaced IAS 39 and consequentially in July 2014 the scope of IAS 39 was relocated to IFRS 9.

* In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7. The paragraphs relating to disclosures that were originally published in this Basis for Conclusions were relocated, if still relevant, to the Basis for Conclusions on IFRS 7.

IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Definitions (paragraphs 11-14 and AG3-AG24)

Financial asset, financial liability and equity instrument (paragraphs 11 and AG3 – AG14)

- BC4 The revised IAS 32 addresses the classification as financial assets, financial liabilities or equity instruments of financial instruments that are indexed to, or settled in, an entity's own equity instruments. As discussed further in paragraphs BC6–BC15, the Board decided to preclude equity classification for such contracts when they (a) involve an obligation to deliver cash or another financial asset or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the entity, (b) in the case of a non-derivative, are not for the receipt or delivery of a fixed number of shares or (c) in the case of a derivative, are not for the exchange of a fixed number of shares for a fixed amount of cash or another financial asset. The Board also decided to preclude equity classification for contracts that are derivatives on derivatives on an entity's own equity. Consistently with this decision, the Board also decided to amend the definitions of financial asset, financial liability and equity instrument in IAS 32 to make them consistent with the guidance about contracts on an entity's own equity instruments. The Board did not reconsider other aspects of the definitions as part of this project to revise IAS 32, for example the other changes to the definitions proposed by the Joint Working Group in its Draft Standard *Financial Instruments and Similar Items* published by the Board's predecessor body, IASC, in 2000.

Allocation of the initial carrying amount to the liability and equity components (paragraphs 31, 32 and AG36-AG38 and Illustrative Examples 9-12)

- BC23 The previous version of IAS 32 did not prescribe a particular method for assigning the initial carrying amount of a compound financial instrument to its separated liability and equity components. Rather, it suggested approaches that might be considered, such as:
- (a) assigning to the less easily measurable component (often the equity component) the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily determinable (a 'with-and-without' method); and
 - (b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts pro rata so that the sum of the components equals the amount of the instrument as a whole (a 'relative fair value' method).
- BC24 This choice was originally justified on the grounds that IAS 32 did not deal with the measurement of financial assets, financial liabilities and equity instruments.
- BC25 However, since the issue of IAS 39,[∇] IFRSs contain requirements for the measurement of financial assets and financial liabilities. Therefore, the view that IAS 32 should not prescribe a particular method for separating compound financial instruments because of the absence of measurement requirements for financial instruments is no longer valid. IAS 39, paragraph 43, requires a financial liability to be measured on initial recognition at its fair value. Therefore, a relative fair value method could result in an initial measurement of the liability component that is not in compliance with IAS 39.
- BC26 After initial recognition, a financial liability that is classified as at fair value through profit or loss is measured at fair value under IAS 39,[#] and other financial liabilities are measured at amortised cost. If the liability component of a compound financial instrument is classified as at fair value through profit or loss, an entity could recognise an immediate gain or loss after initial recognition if it applies a relative fair value method. This is contrary to IAS 32, paragraph 31, which states that no gain or loss arises from recognising the components of the instrument separately.
- BC27 Under the *Framework*, and IASs 32 and 39, an equity instrument is defined as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Paragraph 67 of the *Framework*^{*} further states that the amount at which equity is recognised in the balance sheet is dependent on the measurement of assets and liabilities.
- BC28 The Board concluded that the alternatives in IAS 32 to measure on initial recognition the liability component of a compound financial instrument as a residual amount after separating the equity component or on the basis of a relative fair value method should be eliminated. Instead the liability component should be measured first (including the value of any embedded non-equity derivative features, such as an embedded call feature), and the residual amount assigned to the equity component.
- BC29 The objective of this amendment is to make the requirements about the entity's separation of the liability and equity components of a single compound financial instrument consistent with the requirements about the initial measurement of a financial liability in IAS 39 and the definitions in IAS 32 and the *Framework* of an equity instrument as a residual interest.

[∇] IFRS 9 *Financial Instruments* replaced IAS 39. The requirements of paragraph 43 of IAS 39 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} now paragraph 4.22 of the *Conceptual Framework*

BC52 The Board considered the following ways to improve the financial reporting of instruments that represent a residual interest in the net assets of the entity:

- (a) to continue to classify these instruments as financial liabilities, but amend their measurement so that changes in their fair value would not be recognised;
- (b) to amend IAS 32 to require separation of all puttable instruments into a put option and a host instrument; or
- (c) to amend IAS 32 to provide a limited scope exception so that financial instruments puttable at fair value would be classified as equity, if specified conditions were met.

Amend the measurement of some puttable financial instruments so that changes in their fair value would not be recognised

BC53 The Board decided against this approach because:

- (a) it is inconsistent with the principle in IAS 32 and IAS 39* that only equity instruments are not remeasured after their initial recognition;
- (b) it retains the disadvantage that entities whose instruments are all puttable would have no equity instruments; and
- (c) it introduces a new category of financial liabilities to IAS 39, and thus increases complexity.

Separate all puttable instruments into a put option and a host instrument

BC54 The Board concluded that conducting further research into an approach that splits a puttable share into an equity component and a written put option component (financial liability) would duplicate efforts of the Board's longer-term project on liabilities and equity. Consequently, the Board decided not to proceed with a project at this stage to determine whether a puttable share should be split into an equity component and a written put option component.

Classify as equity instruments puttable instruments that represent a residual interest in the entity

BC55 The Board decided to proceed with proposals to amend IAS 32 to require puttable financial instruments that represent a residual interest in the net assets of the entity to be classified as equity provided that specified conditions are met. The proposals represented a limited scope exception to the definition of a financial liability and a short-term solution, pending the outcome of the longer-term project on liabilities and equity. In June 2006 the Board published an exposure draft proposing that financial instruments puttable at fair value that meet specific criteria should be classified as equity.

BC56 In response to comments received from respondents to that exposure draft, the Board amended the criteria for identifying puttable instruments that represent a residual interest in the entity, to those included in paragraphs 16A and 16B. The Board decided on those conditions for the following reasons:

- (a) to ensure that the puttable instruments, as a class, represent the residual interest in the net assets of the entity;
- (b) to ensure that the proposed amendments are consistent with a limited scope exception to the definition of a financial liability; and

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC114 During redeliberations the Board also considered feedback received on the proposals in the exposure draft related to the treatment of collateral and unit of account. However, as described in greater detail in other sections of this Basis for Conclusions, the Board did not consider it necessary to add application guidance for the treatment of these items.
- BC115 The amendments to the IAS 32 application guidance (paragraphs AG38A–AG38F of IAS 32) are intended to clarify the Board's objective for the offsetting criteria and therefore eliminate inconsistencies noted in applying paragraph 42 of IAS 32.
- BC116 Based on the considerations described in the Basis for Conclusions of these amendments, and summarised in paragraphs BC112–BC115, the Board concluded that the benefits of *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) outweigh the costs to preparers of applying those amendments.

Transition and effective date

- BC117 During redeliberations, the Board originally decided to require retrospective application of the application guidance in paragraphs AG38A–AG38F of IAS 32 for annual periods beginning on or after 1 January 2013. The Board did not expect significant changes in practice as a result of the clarifications made to the application guidance and hence aligned the effective date and transition of these amendments with that of *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7), issued in December 2011.
- BC118 However, the Board received additional feedback from some preparers that the clarifications to the application guidance could change their practice. These preparers indicated that they needed more time to evaluate the effects of the amendments. They indicated that it would be difficult for them to make this assessment in time to allow application of the amendments to the application guidance for the first comparative reporting period.
- BC119 Preparers therefore requested that the Board consider aligning the effective date of the amendments with the revised effective date of IFRS 9 *Financial Instruments* (1 January 2015),* with earlier application allowed. This would give them sufficient time to determine if there would be any changes to their financial statements.
- BC120 The Board believed that the amendments to the IAS 32 application guidance should be effective as soon as possible to ensure comparability of financial statements prepared in accordance with IFRSs. In addition, the Board did not consider that the effective date needed to be aligned with that of IFRS 9. However, the Board also understood the concerns of preparers. The Board therefore decided to require the amendments to the IAS 32 application guidance to be effective for periods beginning 1 January 2014 with earlier application permitted. This would provide a balance between the time needed to implement the amendments with the need for consistent application of the IAS 32 offsetting requirements.

* In the completed version of IFRS 9, issued in July 2014, the Board specified that entities must adopt the completed version of IFRS 9 for annual periods beginning on or after 1 January 2018.

Dissenting opinions

Dissent of James J Leisenring from the issue of IAS 32 in December 2003

- DO1 Mr Leisenring dissents from IAS 32 because, in his view, the conclusions about the accounting for forward purchase contracts and written put options on an issuer's equity instruments that require physical settlement in exchange for cash are inappropriate. IAS 32 requires a forward purchase contract to be recognised as though the future transaction had already occurred. Similarly it requires a written put option to be accounted for as though the option had already been exercised. Both of these contracts result in combining the separate forward contract and the written put option with outstanding shares to create a synthetic liability.
- DO2 Recording a liability for the present value of the fixed forward price as a result of a forward contract is inconsistent with the accounting for other forward contracts. Recording a liability for the present value of the strike price of an option results in recording a liability that is inconsistent with the *Framework*^{*} as there is no present obligation for the strike price. In both instances the shares considered to be subject to the contracts are outstanding, have the same rights as any other shares and should be accounted for as outstanding. The forward and option contracts meet the definition of a derivative and should be accounted for as derivatives rather than create an exception to the accounting required by IAS 39.[#] Similarly, if the redemption feature is embedded in the equity instrument (for example, a redeemable preference share) rather than being a free-standing derivative contract, the redemption feature should be accounted for as a derivative.
- DO3 Mr Leisenring also objects to the conclusion that a purchased put or call option on a fixed number of an issuer's equity instruments is not an asset. The rights created by these contracts meet the definition of an asset and should be accounted for as assets and not as a reduction in equity. These contracts also meet the definition of derivatives that should be accounted for as such consistently with IAS 39.

* The reference to the *Framework* is to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Effective for annual periods
beginning on or after 1 January 2005

Illustrative Examples
Hong Kong Accounting Standard 32

Financial Instruments: Presentation



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IAS 32 *Financial Instruments: Presentation* Illustrative examples

These examples accompany, but are not part of, IAS 32.

Accounting for contracts on equity instruments of an entity

- IE1 The following examples* illustrate the application of paragraphs 15–27 and IFRS 9 ~~IAS 39~~ to the accounting for contracts on an entity's own equity instruments (other than the financial instruments specified in paragraphs 16A and 16B or paragraphs 16C and 16D).

Example 1: Forward to buy shares

- IE2 This example illustrates the journal entries for forward purchase contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e. the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	1 February 20X2
Maturity date	31 January 20X3
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on 1 February 20X2	CU0
Fair value of forward on 31 December 20X2	CU6,300
Fair value of forward on 31 January 20X3	CU2,000

(a) *Cash for cash ('net cash settlement')*

- IE3 In this subsection, the forward purchase contract on the entity's own shares will be settled net in cash, i.e. there is no receipt or delivery of the entity's own shares upon settlement of the forward contract.

On 1 February 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for a payment of CU104,000 in cash (i.e. CU104 per share) on 31 January 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

* In these examples, monetary amounts are denominated in 'currency units' (CU).

(c) Cash for shares ('gross physical settlement')

- IE5 Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B (CU104 x 1,000) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

1 February 20X2

Dr	Equity	CU100,000	
	Cr	Liability	CU100,000

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IFRS 9-IAS 39, paragraph B5.1.1-AG64).

31 December 20X2

Dr	Interest expense	CU3,660	
	Cr	Liability	CU3,660

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 20X3

Dr	Interest expense	CU340	
	Cr	Liability	CU340

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr	Liability	CU104,000	
	Cr	Cash	CU104,000

To record the settlement of the obligation to redeem Entity A's own shares for cash.

(d) Settlement options

- IE6 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward repurchase contract is a financial asset or a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the forward contract as a derivative.

Hong Kong Accounting Standard 33

Earnings per Share



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information in the consolidated financial statements.

- 4A If an entity presents items of profit or loss in a separate ~~income~~ statement as described in paragraph 10A of HKAS 1 *Presentation of Financial Statements* (as amended in 2011), it presents earnings per share only in that separate statement.

Definitions

- 5 The following terms are used in this Standard with the meanings specified:

Antidilution is an increase in earnings per share or a reduction in loss per share resulting 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.

Dilution is a reduction in earnings per share or an increase in loss per share resulting 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.

Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares.

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.

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.

- 6 Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends.

period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares; and

- (b) the weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

Earnings

- 33 For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, as calculated in accordance with paragraph 12, by the after-tax effect of:**

- (a) any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity as calculated in accordance with paragraph 12;**
- (b) any interest recognised in the period related to dilutive potential ordinary shares; and**
- (c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.**

- 34 After the potential ordinary shares are converted into ordinary shares, the items identified in paragraph 33(a)-(c) no longer arise. Instead, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. Therefore, profit or loss attributable to ordinary equity holders of the parent entity calculated in accordance with paragraph 12 is adjusted for the items identified in paragraph 33(a)-(c) and any related taxes. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method (see ~~paragraph 9 of HKAS 39 *Financial Instruments: Recognition and Measurement*~~ HKFRS 9 *Financial Instruments*).

- 35 The conversion of potential ordinary shares may lead to consequential changes in income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in profit or reduction in loss may lead to an increase in the expense related to a non-discretionary employee profit-sharing plan. For the purpose of calculating diluted earnings per share, profit or loss attributable to ordinary equity holders of the parent entity is adjusted for any such consequential changes in income or expense.

Shares

- 36 For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares calculated in accordance with paragraphs 19 and 26, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares.**

- 54 The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares. In that case, if the effect is dilutive, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period. If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used. Because the market price may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.
- 55 The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the number of ordinary shares included in the diluted earnings per share calculation is based on both conditions (ie earnings to date and the current market price at the end of the reporting period). Contingently issuable ordinary shares are not included in the diluted earnings per share calculation unless both conditions are met.
- 56 In other cases, the number of ordinary shares contingently issuable depends on a condition other than earnings or market price (for example, the opening of a specific number of retail stores). In such cases, assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period.
- 57 Contingently issuable potential ordinary shares (other than those covered by a contingent share agreement, such as contingently issuable convertible instruments) are included in the diluted earnings per share calculation as follows:
- (a) an entity determines whether the potential ordinary shares may be assumed to be issuable on the basis of the conditions specified for their issue in accordance with the contingent ordinary share provisions in paragraphs 52-56; and
 - (b) if those potential ordinary shares should be reflected in diluted earnings per share, an entity determines their impact on the calculation of diluted earnings per share by following the provisions for options and warrants in paragraphs 45-48, the provisions for convertible instruments in paragraphs 49-51, the provisions for contracts that may be settled in ordinary shares or cash in paragraphs 58-61, or other provisions, as appropriate.

However, exercise or conversion is not assumed for the purpose of calculating diluted earnings per share unless exercise or conversion of similar outstanding potential ordinary shares that are not contingently issuable is assumed.

Contracts that may be settled in ordinary shares or cash

- 58 **When an entity has issued a contract that may be settled in ordinary shares or in cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.**

shares outstanding and any consequent adjustments to profit or loss attributable to ordinary equity holders. The disclosure of the terms and conditions of such financial instruments and other contracts is encouraged, if not otherwise required (see HKFRS 7 *Financial Instruments: Disclosures*).

- 73 If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of comprehensive income other than one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard. Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. If a component of the statement of comprehensive income is used that is not reported as a line item in the statement of comprehensive income, a reconciliation shall be provided between the component used and a line item that is reported in the statement of comprehensive income.
- 73A Paragraph 73 applies also to an entity that discloses, in addition to basic and diluted earnings per share, amounts per share using a reported item of profit or loss, other than one required by this Standard.

Effective date

- 74 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies the Standard for a period beginning before 1 January 2005, it shall disclose that fact.
- 74a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the same effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.
- 74A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it added paragraphs 4A, 67A, 68A and 73A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 74B HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 4, 40 and A11. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 74C HKFRS 13, issued in June 2011, amended paragraphs 8, 47A and A2. An entity shall apply those amendments when it applies HKFRS 13.
- 74D *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraphs 4A, 67A, 68A and 73A. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 74E HKFRS 9 *Financial Instruments*, as issued in September 2014, amended paragraph 34. An entity shall apply that amendment when it applies HKFRS 9.

Withdrawal of other pronouncements

- 75 This Standard supersedes SSAP 5 *Earnings Per Share* revised in 1998.
- 76 This Standard supersedes Interpretation 10 *Earnings Per Share—Financial Instruments and Other Contracts that May Be Settled in Shares*.

HKAS 34
Revised December 2016 September 2018

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 34

Interim Financial Reporting



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- (d) a statement of cash flows for the period;
- (e) notes, comprising significant accounting policies and other explanatory information;
- (ea) comparative information in respect of the preceding period as specified in paragraphs 38 and 38A of HKAS 1; and
- (f) a statement of financial position as at the beginning of the preceding 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 in accordance with paragraphs 40A-40D of HKAS 1.

An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

- 6 In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements. This Standard defines the minimum content of an interim financial report as including condensed financial statements and selected explanatory notes. The interim financial report is intended to provide an update on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.
- 7 Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in HKAS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. Nor does this Standard prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement guidance in this Standard applies also to complete financial statements for an interim period, and such statements would include all of the disclosures required by this Standard (particularly the selected note disclosures in paragraph 16A) as well as those required by other HKFRSs.

Minimum components of an interim financial report

- 8 An interim financial report shall include, at a minimum, the following components:
- (a) a condensed statement of financial position;
 - (b) a condensed statement or condensed statements of profit or loss and other comprehensive income;
 - (c) a condensed statement of changes in equity;
 - (d) a condensed statement of cash flows; and
 - (e) selected explanatory notes.
- 8A If an entity presents items of profit or loss in a separate statement as described in paragraph 10A of HKAS 1 (as amended in 2011), it presents interim condensed information from that statement.

Form and content of interim financial statements

- 9 If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements shall conform to the requirements of HKAS 1 for a complete set of financial statements.

- 10** If an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements shall include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard. Additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading.
- 11** In the statement that presents the components of profit or loss for an interim period, an entity shall present basic and diluted earnings per share for that period when the entity is within the scope of HKAS 33 *Earnings per Share*.*
- 11A** If an entity presents items of profit or loss in a separate statement as described in paragraph 10A of HKAS 1 (as amended in 2011), it presents basic and diluted earnings per share in that separate statement.
- 12** HKAS 1 (as revised in 2007) provides guidance on the structure of financial statements. The Implementation Guidance for HKAS 1 illustrates ways in which the statement of financial position, statement of comprehensive income and statement of changes in equity may be presented.
- 13** [Deleted]
- 14** An interim financial report is prepared on a consolidated basis if the entity's most recent annual financial statements were consolidated statements. The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. If an entity's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, this Standard neither requires nor prohibits the inclusion of the parent's separate statements in the entity's interim financial report.

Significant events and transactions

- 15** An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.
- 15A** A user of an entity's interim financial report will have access to the most recent annual financial report of that entity. Therefore, it is unnecessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was reported in the notes in the most recent annual financial report.
- 15B** The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.
- (a) the write-down of inventories to net realisable value and the reversal of such a write-down;
 - (b) recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, assets arising from contracts with customers, or other assets, and the reversal of such an impairment loss;
 - (c) the reversal of any provisions for the costs of restructuring;
 - (d) acquisitions and disposals of items of property, plant and equipment;
 - (e) commitments for the purchase of property, plant and equipment;
 - (f) litigation settlements;
 - (g) corrections of prior period errors;

* This paragraph was amended by *Improvements to HKFRSs* issued in October 2008 to clarify the scope of HKAS 34.

- (h) changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;
 - (i) any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;
 - (j) related party transactions;
 - (k) transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;
 - (l) changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and
 - (m) changes in contingent liabilities or contingent assets.
- 15C Individual HKFRSs provide guidance regarding disclosure requirements for many of the items listed in paragraph 15B. When an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual reporting period, its interim financial report should provide an explanation of and an update to the relevant information included in the financial statements of the last annual reporting period.
- ~~16–18~~ [Deleted]

Other disclosures

- 16A** In addition to disclosing significant events and transactions in accordance with paragraphs 15–15C, an entity shall include the following information, in the notes to its interim financial statements or elsewhere in the interim financial report. The following disclosures shall be given either in the interim financial statements or incorporated by cross-reference from the interim financial statements to some other statement (such as management commentary or risk report) that is available to users of the financial statements on the same terms as the interim financial statements and at the same time. If users of the financial statements do not have access to the information incorporated by cross-reference on the same terms and at the same time, the interim financial report is incomplete. The information shall normally be reported on a financial year-to-date basis.
- (a) a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.
 - (b) explanatory comments about the seasonality or cyclicity of interim operations.
 - (c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.
 - (d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years.
 - (e) issues, repurchases, and repayments of debt and equity securities.
 - (f) dividends paid (aggregate or per share) separately for ordinary shares and other shares.
 - (g) the following segment information (disclosure of segment information is required in an entity's interim financial report only if HKFRS 8 *Operating Segments* requires that entity to disclose segment information in its annual financial statements):
 - (i) revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
 - (ii) intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
 - (iii) a measure of profit or loss.

- (iv) a measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last annual financial statements for that reportable segment.
- (v) a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss.
- (vi) a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation.
- (h) events after the interim period that have not been reflected in the financial statements for the interim period.
- (i) the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by HKFRS 3 *Business Combinations*.
- (j) for financial instruments, the disclosures about fair value required by paragraphs 91-93(h), 94-96, 98 and 99 of HKFRS 13 *Fair Value Measurement* and paragraphs 25, 26 and 28-30 of HKFRS 7 *Financial Instruments: Disclosures*.
- (k) for entities becoming, or ceasing to be, investment entities, as defined in HKFRS 10 *Consolidated Financial Statements*, the disclosures in HKFRS 12 *Disclosure of Interests in Other Entities* paragraph 9B.
- (l) the disaggregation of revenue from contracts with customers required by paragraphs 114-115 of HKFRS 15 *Revenue from Contracts with Customers*.

17-18 [Deleted]

Disclosure of compliance with HKFRSs

- 19 If an entity's interim financial report is in compliance with this Standard, that fact shall be disclosed. An interim financial report shall not be described as complying with HKFRSs unless it complies with all the requirements of HKFRSs.

Periods for which interim financial statements are required to be presented

- 20 Interim reports shall include interim financial statements (condensed or complete) for periods as follows:
- (a) statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year.
 - (b) statements of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit or loss and other comprehensive income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. As permitted by HKAS 1 (as amended in 2011), an interim report may present for each period a statement or statements of profit or loss and other comprehensive income.
 - (c) statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

- 45 To allow accounting changes to be reflected as of an interim date within the financial year would allow two differing accounting policies to be applied to a particular class of transactions within a single financial year. The result would be interim allocation difficulties, obscured operating results, and complicated analysis and understandability of interim period information.

Withdrawal of SSAP 25

- 45A This Standard supersedes SSAP 25 *Interim Financial Reporting* (revised in 2001).

Effective date

- 46 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.
- 47 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 4, 5, 8, 11, 12 and 20, deleted paragraph 13 and added paragraphs 8A and 11A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 48 HKFRS 3 (as revised in 2008) amended paragraph 16(i). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period.
- 49 Paragraphs 15, 27, 35 and 36 were amended, paragraphs 15A–15C and 16A were added and paragraphs 16–18 were deleted by *Improvements to HKFRSs* issued in May 2010. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 50 HKFRS 13, issued in June 2011, added paragraph 16A(j). An entity shall apply that amendment when it applies HKFRS 13.
- 51 *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 8, 8A, 11A and 20. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 52 *Annual Improvements 2009-2011 Cycle*, Issued in June 2012, amended paragraph 5 as a consequential amendment derived from the amendment to HKAS 1 *Presentation of Financial Statements*. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 53 *Annual Improvements 2009-2011 Cycle*, issued in June 2012, amended paragraph 16A. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 54 *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraph 16A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies that amendment earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 55 ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~ HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 15B and 16A. An entity shall apply those amendments when it applies HKFRS 15.

- 56 *Annual Improvements to HKFRSs 2012–2014 Cycle*, issued in October 2014, amended paragraph 16A. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 57 *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraph 5. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application of that amendment is permitted.

Basis for Conclusions on IAS 34 *Interim Financial Reporting*

This Basis for Conclusions accompanies, but is not part of, IAS 34.

HKAS 34 is based on IAS 34 *Interim Financial Reporting*. In approving HKAS 34, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 34. Accordingly, there are no significant differences between HKAS 34 and IAS 34. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 34 referred to below generally correspond with those in HKAS 34.

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in amending paragraphs 15–18 of IAS 34 *Interim Financial Reporting* as part of *Improvements to IFRSs* issued in May 2010. Those changes aim to emphasise the disclosures principles in IAS 34 and to add further guidance to illustrate how to apply these principles.
- BC2 IAS 34 was developed by the International Accounting Standards Committee (IASC) in 1998 and did not include a Basis for Conclusions.

Significant events and transactions

- BC3 In *Improvements to IFRSs* issued in May 2010, the Board addressed requests for clarification of the disclosures required by IAS 34 when considered against changes in the disclosure requirements of other IFRSs. IAS 34 was issued by the Board's predecessor body, IASC, in 1998. In the light of recent improvements to disclosure requirements, many users of financial statements asked the Board to consider whether particular disclosures required by IFRS 7 *Financial Instruments: Disclosures* for annual financial statements should also be required in interim financial statements. IAS 34 sets out disclosure principles to determine what information should be disclosed in an interim financial report. The Board concluded that amending IAS 34 to place greater emphasis on those principles and the inclusion of additional examples relating to more recent disclosure requirements, ie fair value measurements, would improve interim financial reporting.
- BC4 As part of *Improvements to IFRSs* issued in May 2010, the Board deleted paragraph 18 of IAS 34 because it repeats paragraph 10 of IAS 34 and because the Board's intention is to emphasise those disclosures that are required rather than those that are not required.

Content of an interim financial report

- BC5 As part of *Annual Improvements 2009-2011 Cycle* (issued in May 2012) the Board amended paragraph 5 to achieve consistency with paragraphs 10(ea) and 10(f) of IAS 1 *Presentation of Financial Statements*.

Selected explanatory notes

- BC6 In *Annual Improvements 2009-2011 Cycle* (issued in May 2012) the Board decided to clarify the requirements on segment information for total assets and liabilities for each reportable segment to enhance consistency with the requirements in paragraph 23 of IFRS 8 *Operating Segments*. The amendment clarifies that the total assets and liabilities for a particular reportable segment are required to be disclosed if, and only if:
- (a) a measure of total assets or of total liabilities (or both) is regularly provided to the chief operating decision maker; and
 - (b) there has been a material change from those measures disclosed in the last annual financial statements for that reportable segment.

Hong Kong Accounting Standard 36

Impairment of Assets



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Accounting Standard 36

Impairment of Assets

Objective

- 1 The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Scope

- 2 This Standard shall be applied in accounting for the impairment of all assets, other than:
- (a) inventories (see HKAS 2 *Inventories*);
 - (b) ~~assets arising from construction contracts (see HKAS 11 *Construction Contracts*)~~ contract assets and assets arising from costs to obtain or fulfil a contract that are recognised in accordance with HKFRS 15 *Revenue from Contracts with Customers*;
 - (c) deferred tax assets (see HKAS 12 *Income Taxes*);
 - (d) assets arising from employee benefits (see HKAS 19 *Employee Benefits*);
 - (e) financial assets that are within the scope of HKFRS 9 *Financial Instruments* ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~;
 - (f) investment property that is measured at fair value (see HKAS 40 *Investment Property*);
 - (g) biological assets related to agricultural activity within the scope of HKAS 41 *Agriculture* that are measured at fair value less costs to sell;
 - (h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4 *Insurance Contracts*; and
 - (i) non-current assets (or disposal groups) classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.
- 3 This Standard does not apply to inventories, assets arising from construction contracts, deferred tax assets, assets arising from employee benefits, or assets classified as held for sale (or included in a disposal group that is classified as held for sale) because existing HKFRSs applicable to these assets contain requirements for recognising and measuring these assets.

4 This Standard applies to financial assets classified as:

- (a) subsidiaries, as defined in HKFRS 10 *Consolidated Financial Statements*;
- (b) associates, as defined in HKAS 28 *Investments in Associates and Joint Ventures*; and
- (c) joint ventures, as defined in HKFRS 11 *Joint Arrangements*.

For impairment of other financial assets, refer to HKFRS 9~~HKAS 39~~.

5 This Standard does not apply to financial assets within the scope of HKFRS 9~~HKAS 39~~, investment property measured at fair value within the scope of HKAS 40, or biological assets related to agricultural activity measured at fair value less costs to sell within the scope of HKAS 41. However, this Standard applies to assets that are carried at revalued amount (ie fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses) in accordance with other HKFRSs, such as the revaluation model in HKAS 16 *Property, Plant and Equipment* and HKAS 38 *Intangible Assets*. The only difference between an asset's fair value and its fair value less costs of disposal is the direct incremental costs attributable to the disposal of the asset.

- (a) If the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount. In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated.
- (b) [deleted]
- (c) If the disposal costs are not negligible, the fair value less costs of disposal of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount. In this case, after the revaluation requirements have been applied, an entity applies this Standard to determine whether the asset may be impaired.

- 140 Entities to which paragraph 139 applies are encouraged to apply the requirements of this Standard before the effective dates specified in paragraph 139. However, if an entity applies this Standard before those effective dates, it also shall apply HKFRS 3 and HKAS 38 at the same time.
- 140A HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 61, 120, 126 and 129. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 140B HKFRS 3 (as revised in 2008) amended paragraphs 65, 81, 85 and 139, deleted paragraphs 91-95 and 138 and added Appendix C. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 140C Paragraph 134(e) was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 140D *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* and HKAS 27), issued in October 2008, added paragraph 12(h). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the related amendments in paragraphs 4 and 38A of HKAS 27 for an earlier period, it shall apply the amendment in paragraph 12(h) at the same time.
- 140E *Improvements to HKFRSs* issued in May 2009 amended paragraph 80(b). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 140F ~~[Deleted]/[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 140G ~~[Deleted]/[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 140H HKFRS 10 and HKFRS 11, issued in June 2011, amended paragraph 4, the heading above paragraph 12(h) and paragraph 12(h). An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 140I HKFRS 13, issued in June 2011, amended paragraphs 5, 6, 12, 20, 22, 28, 78, 105, 111, 130 and 134, deleted paragraphs 25-27 and added paragraph 53A. An entity shall apply those amendments when it applies HKFRS 13.
- 140J In June 2013 paragraphs 130 and 134 and the heading above paragraph 138 were amended. An entity shall apply those amendments retrospectively for annual periods beginning on or after 1 January 2014. Earlier application is permitted. An entity shall not apply those amendments in periods (including comparative periods) in which it does not also apply HKFRS 13.

140K [Deleted]

140L HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 2. An entity shall apply that amendment when it applies HKFRS 15.

140M HKFRS 9, as issued in September 2014, amended paragraphs 2, 4 and 5 and deleted paragraphs 140F, 140G and 140K. An entity shall apply those amendments when it applies HKFRS 9.

Withdrawal of SSAP 31

141 This Standard supersedes SSAP 31 *Impairment of Assets* (issued in 2001).

Appendix B

Amendment to HKAS 16

The amendment in this appendix shall be applied when an entity applies HKAS 16 Property, Plant and Equipment-. ~~It This appendix~~ is superseded when HKAS 36 Impairment of Assets becomes effective. This appendix replaces the consequential amendments made by HKAS 16 to SSAP 31 (which is referred to in HKAS 16 Appendix paragraph A4 as “HKAS 36”). HKAS 36 incorporates the requirements of the paragraphs in this appendix. Consequently, the amendments from HKAS 16 are not necessary once an entity is subject to HKAS 36. Accordingly, this appendix is applicable only to entities that elect to apply HKAS 16 before its effective date.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

*Basis for Conclusions on
Hong Kong Accounting Standard 36*

Impairment of Assets



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

BASIS FOR CONCLUSIONS ON IAS 36 *IMPAIRMENT OF ASSETS*

HKAS 36 is based on IAS 36 *Impairment of Assets*. In approving HKAS 36, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 36. Accordingly, there are no significant differences between HKAS 36 and IAS 36. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IAS 36 referred to below generally correspond with those in HKAS 36.

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* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

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- BC3 The previous version of IAS 36 was accompanied by a Basis for Conclusions summarising IASC's considerations in reaching some of its conclusions in that Standard. For convenience, the Board has incorporated into this Basis for Conclusions material from the previous Basis for Conclusions that discusses matters the Board did not consider. That material is contained in paragraphs denoted by numbers with the prefix BCZ. The views expressed in paragraphs denoted by numbers with the prefix BCZ are those of IASC.

Scope (paragraph 2)

- BCZ4 IAS 2 *Inventories* requires an enterprise to measure the recoverable amount of inventory at its net realisable value. IASC believed that there was no need to revise this requirement because it was well accepted as an appropriate test for recoverability of inventories. No major difference exists between IAS 2 and the requirements included in IAS 36 (see paragraphs BCZ37-BCZ39).
- BCZ5 IAS 11 *Construction Contracts*^α and IAS 12 *Income Taxes* already deal with the impairment of assets arising from construction contracts and deferred tax assets respectively. Under both IAS 11 and IAS 12, recoverable amount is, in effect, determined on an undiscounted basis. IASC acknowledged that this was inconsistent with the requirements of IAS 36. However, IASC believed that it was not possible to eliminate that inconsistency without fundamental changes to IAS 11 and IAS 12. IASC had no plans to revise IAS 11 or IAS 12.
- BCZ6 IAS 19 *Employee Benefits* contains an upper limit on the amount at which an enterprise should recognise an asset arising from employee benefits. Therefore, IAS 36 does not deal with such assets. The limit in IAS 19 is determined on a discounted basis that is broadly compatible with the requirements of IAS 36. *
- BCZ7 IAS 39 *Financial Instruments: Recognition and Measurement*[#] sets out the requirements for impairment of financial assets.
- BCZ8 IAS 36 is applicable to all assets, unless specifically excluded, regardless of their classification as current or non-current. Before IAS 36 was issued, there was no International Accounting Standard on accounting for the impairment of current assets other than inventories.

Measuring recoverable amount (paragraphs 18-57)

- BCZ9 In determining the principles that should govern the measurement of recoverable amount, IASC considered, as a first step, what an enterprise will do if it discovers that an asset is impaired. IASC concluded that, in such cases, an enterprise will either keep the asset or dispose of it. For example, if an enterprise discovers that the service potential of an asset has decreased:

- (a) the enterprise may decide to sell the asset if the net proceeds from the sale would provide a higher return on investment than continuing use in operations;
or

^α IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts*. IFRS 15 includes requirements for the impairment of some assets arising from contracts with customers and amended paragraph 2 of IAS 36 for consistency with the requirements of IFRS 15.

* sentence deleted when IAS 19 *Employee Benefits* was amended in 2011.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (c) value in use is the enterprise's estimate of the present value of the future cash flows to be derived from continuing use and disposal of the asset.

These bases all consider the time value of money and the risks that the amount and timing of the actual cash flows to be received from an asset might differ from estimates. Fair value and net selling price may differ from value in use because the market may not use the same assumptions as an individual enterprise.

Recoverable amount based on the sum of undiscounted cash flows

BCZ12 Some argue that recoverable amount should be measured as the sum of undiscounted future cash flows from an asset. They argue that:

- (a) historical cost accounting is not concerned with measuring the economic value of assets. Therefore, the time value of money should not be considered in estimating the amount that will be recovered from an asset.
- (b) it is premature to use discounting techniques without further research and debates on:
 - (i) the role of discounting in the financial statements; and
 - (ii) how assets should be measured generally.

If financial statements include assets that are carried on a variety of different bases (historical cost, discounted amounts or other bases), this will be confusing for users.

- (c) identifying an appropriate discount rate will often be difficult and subjective.
- (d) discounting will increase the number of impairment losses recognised. This, coupled with the requirement for reversals of impairment losses, introduces a volatile element into the income statement. It will make it harder for users to understand the performance of an enterprise.

A minority of commentators on E55 *Impairment of Assets* supported this view.

BCZ13 IASC rejected measurement of recoverable amount based on the sum of undiscounted cash flows because:

- (a) the objective of the measurement of recoverable amount is to reflect an investment decision. Money has a time value, even when prices are stable. If future cash flows were not discounted, two assets giving rise to cash flows of the same amount but with different timings would show the same recoverable amount. However, their current market values would be different because all rational economic transactions take account of the time value of money.
- (b) measurements that take into consideration the time value of money are more relevant to investors, other external users of financial statements and management for resource allocation decisions, regardless of the general measurement basis adopted in the financial statements.
- (c) many enterprises were already familiar with the use of discounting techniques,

particularly for supporting investment decisions.

- (d) discounting was already required for other areas of financial statements that are based on expectations of future cash flows, such as long-term provisions and employee benefit obligations.
- (e) users are better served if they are aware on a timely basis of assets that will not generate sufficient returns to cover, at least, the time value of money.

Recoverable amount based on fair value

BCZ14 IAS 32 *Financial Instruments: Disclosure and Presentation*[†] and a number of other International Accounting Standards define fair value[#] as:

“... the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction...”

BCZ15 International Accounting Standards include the following requirements or guidance for measuring fair value^Ω:

- (a) for the purpose of revaluation of an item of property, plant or equipment to its fair value, IAS 16 *Property, Plant and Equipment* indicates that fair value is usually an asset’s market value, normally determined by appraisal undertaken by professionally qualified valuers and, if no market exists, fair value is based on the asset’s depreciated replacement cost.
- (b) for the purpose of revaluation of an intangible asset to its fair value, IASC proposed in E60 *Intangible Assets* that fair value be determined by reference to market values obtained from an active market. E60 proposed a definition of an active market.*
- (c) IASC proposed revisions to IAS 22 (see E61 *Business Combinations*) so that fair value would be determined without consideration of the acquirer’s intentions for the future use of an asset.^Φ
- (d) IAS 39^δ indicates that if an active market exists, the fair value of a financial instrument is based on a quoted market price. If there is no active market, fair value is determined by using estimation techniques such as market values of similar types of financial instruments, discounted cash flow analysis and option pricing models.

[†] In 2005 the IASB amended IAS 32 as *Financial Instruments: Presentation*.

[#] IFRS 13, issued in May 2011, defines fair value as an exit price.

^Ω IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value. As a consequence the relevant requirements in IAS 16 and IAS 39 have been deleted from those Standards.

* IASC approved an International Accounting Standard on intangible assets in 1998

^Φ IASC approved revisions to IAS 22 *Business Combinations* in 1998.

^δ The IASB’s project to revise IAS 32 and IAS 39 in 2003 resulted in the relocation of the requirements on fair value measurement from IAS 32 to IAS 39. Subsequently to that, IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. In 2011 the IASB’s project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.

Recoverable amount based on the higher of net selling price and value in use^{*}

BCZ23 The requirement that recoverable amount should be the higher of net selling price and value in use stems from the decision that measurement of the recoverable amount of an asset should reflect the likely behaviour of a rational management. Furthermore, no preference should be given to the market's expectation of the recoverable amount of an asset (basis for net selling price) over a reasonable estimate performed by the individual enterprise which owns the asset (basis for value in use) or vice versa (see paragraphs BCZ17-BCZ20 and BCZ22). It is uncertain whether the assumptions of the market or the enterprise are more likely to be true. Currently, perfect markets do not exist for many of the assets within the scope of IAS 36 and it is unlikely that predictions of the future will be entirely accurate, regardless of who makes them.

BCZ24 IASC acknowledged that an enterprise would use judgement in determining whether an impairment loss needed to be recognised. For this reason, IAS 36 included some safeguards to limit the risk that an enterprise may make an over-optimistic (pessimistic) estimate of recoverable amount:

- (a) IAS 36 requires a formal estimate of recoverable amount whenever there is an indication that:
 - (i) an asset may be impaired; or
 - (ii) an impairment loss may no longer exist or may have decreased.

For this purpose, IAS 36 includes a relatively detailed (although not exhaustive) list of indicators that an asset may be impaired (see paragraphs 12 and 111 of IAS 36).

- (b) IAS 36 provides guidelines for the basis of management's projections of future cash flows to be used to estimate value in use (see paragraph 33 of IAS 36).

BCZ25 IASC considered the cost of requiring an enterprise to determine both net selling price and value in use, if the amount determined first is below an asset's carrying amount. IASC concluded that the benefits of such a requirement outweigh the costs.

BCZ26 The majority of the commentators on E55 supported IASC's view that recoverable amount should be measured at the higher of net selling price and value in use.

Assets held for disposal

BCZ27 IASC considered whether the recoverable amount of an asset held for disposal should be measured only at the asset's net selling price. When an enterprise expects to dispose of an asset within the near future, the net selling price of the asset is normally close to its value in use. Indeed, the value in use usually consists mostly of the net proceeds to be received for the asset, since future cash flows from continuing use are usually close to nil. Therefore, IASC believed that the definition of recoverable amount as included in IAS 36 is appropriate for assets held for disposal without a need for further requirements or guidance.

^{*} In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

- (b) for convergence reasons, the level of the goodwill impairment test should be the same as the level in US Financial Accounting Standards Board Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS 142) (ie the reporting unit level).
 - (c) cash-generating units that constitute businesses with similar characteristics should, as is required by SFAS 142, be aggregated and treated as single units, notwithstanding that they may be monitored independently for internal purposes.
- BC146 In relation to (a), the Board reaffirmed the conclusion it reached when developing the Exposure Draft that requiring goodwill to be allocated to at least the segment level is necessary to avoid entities erroneously concluding that, when a business combination enhances the value of all of the acquirer's pre-existing cash-generating units, any goodwill acquired in that combination could be tested for impairment only at the level of the entity itself.
- BC147 In relation to (b), the Board noted that SFAS 142 requires goodwill to be tested for impairment at a level of reporting referred to as a 'reporting unit'. A reporting unit is an operating segment (as defined in SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*[†]) or one level below an operating segment (referred to as a component). A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. However, two or more components of an operating segment must be aggregated and deemed a single reporting unit if the components have similar economic characteristics. An operating segment is deemed to be a reporting unit if all of its components are similar, if none of its components is a reporting unit, or if it comprises only a single component.
- BC148 Therefore, unlike IAS 36, SFAS 142 places a limit on how far goodwill can be 'pushed down' for impairment testing (ie one level below an operating segment).
- BC149 In deciding not to converge with SFAS 142 on the level of the goodwill impairment test, the Board noted the following findings from the field visits and North American round-table discussions:
- (a) most of the US registrant field visit participants stated that the Board's proposals on the level of the goodwill impairment test would result, in practice, in goodwill being tested for impairment at the same level at which it is tested in accordance with SFAS 142. However, several stated that under the Board's proposals, goodwill would be tested for impairment at a lower level than under SFAS 142. Nevertheless, they believe that the Board's approach provides users and management with more useful information.

[†] The basis for identifying 'operating segments' under SFAS 131 differs from the basis for identifying segments based on the entity's primary reporting format under ~~IAS 14~~IFRS 8. SFAS 131 defines an operating segment as a component of an enterprise (a) that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses relating to transactions with other components of the enterprise; (b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and (c) for which discrete financial information is available. IAS 14 was replaced by IFRS 8 in 2006. See paragraph BC150A.

BCZ183 Opponents of reversals of impairment losses argue that:

- (a) reversals of impairment losses are contrary to the historical cost accounting system. When the carrying amount is reduced, recoverable amount becomes the new cost basis for an asset. Consequently, reversing an impairment loss is no different from revaluing an asset upward. Indeed, in many cases, recoverable amount is similar to the measurement basis used for the revaluation of an asset. Hence, reversals of impairment losses should be either prohibited or recognised directly in equity as a revaluation.
- (b) reversals of impairment losses introduce volatility in reported earnings. Periodic, short-term income measurements should not be affected by unrealised changes in the measurement of a long-lived asset.
- (c) the result of reversals of impairment losses would not be useful to users of financial statements since the amount of a reversal under IAS 36 is limited to an amount that does not increase the carrying amount of an asset above its depreciated historical cost. Neither the amount reversed nor the revised carrying amount have any information content.
- (d) in many cases, reversals of impairment losses will result in the implicit recognition of internally generated goodwill.
- (e) reversals of impairment losses open the door to abuse and income ‘smoothing’ in practice.
- (f) follow-up to verify whether an impairment loss needs to be reversed is costly.

BCZ184 IASC’s reasons for requiring reversals of impairment losses were the following:

- (a) it is consistent with the *Framework*[#] and the view that future economic benefits that were not previously expected to flow from an asset have been reassessed as probable.
- (b) a reversal of an impairment loss is not a revaluation and is consistent with the historical cost accounting system as long as the reversal does not result in the carrying amount of an asset exceeding its original cost less amortisation/depreciation, had the impairment loss not been recognised. Accordingly, the reversal of an impairment loss should be recognised in the income statement and any amount in excess of the depreciated historical cost should be accounted for as a revaluation.
- (c) impairment losses are recognised and measured based on estimates. Any change in the measurement of an impairment loss is similar to a change in estimate. IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*^{*} requires that a change in accounting estimate should be included in the determination of the net profit or loss in (a) the period of the change, if the change affects the period only, or (b) the period of the change and future periods, if the change affects both.

[#] The reference to the *Framework* is to IASC's *Framework for Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

^{*} IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* was superseded in 2003 by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Changes as a result of *Improvements to IFRSs* (2008)*

BC209A The Board noted that the disclosures that IAS 36 requires when value in use is used to determine recoverable amount differ from those required when fair value less costs to sell is used. These differing requirements appear inconsistent when a similar valuation methodology (discounted cash flows) has been used. Therefore, as part of *Improvements to IFRSs* issued in May 2008, the Board decided to require the same disclosures for fair value less costs to sell and value in use when discounted cash flows are used to estimate recoverable amount.

Changes as a result of IFRS 13 *Fair Value Measurement*

BC209B In developing IFRS 13, issued in May 2011, the Board was asked by users of financial statements to minimise the differences between the disclosures made about impaired assets in IFRSs and in US GAAP (which requires assets to be tested for impairment by comparing their carrying amount with their fair value). The Board noted that the disclosure requirements in IAS 36 were developed specifically to ensure consistency in the disclosure of information about impaired assets so that the same type of information is provided whether the recoverable amount was determined on the basis of value in use or fair value less costs of disposal. Consequently, the Board did not think it would be appropriate to require an entity to provide information when the recoverable amount is determined on the basis of fair value less costs of disposal (ie those required in IFRS 13) that is significantly different from what the entity would provide when the recoverable amount is determined on the basis of value in use.

BC209C Although IFRSs and US GAAP have different impairment models, the Board concluded that requiring the following information (in addition to what IAS 36 currently requires) about impaired assets measured at fair value less costs of disposal would improve comparability between entities applying IFRSs and those applying US GAAP as well as increase the convergence of IFRSs and US GAAP:

- (a) the fair value less costs of disposal;
- (b) the level of the fair value hierarchy within which the fair value less costs of disposal is categorised in its entirety (Level 1, 2 or 3);
- (c) if applicable, changes to valuation techniques and reasons for those changes; and
- (d) quantitative information about significant inputs used when measuring fair value less costs of disposal (along with a conforming amendment to the disclosures about value in use).

BC209D In addition, those disclosures are consistent with the disclosures required for non-recurring fair value measurements in IFRS 13 and in US GAAP.

* This heading and paragraph BC209A were added by *Improvements to IFRSs* issued in May 2008.

Illustrative Examples
Hong Kong Accounting Standard 36

Impairment of Assets



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Example 2 - Calculation of value in use and recognition of an impairment loss

In this example, tax effects are ignored.

Background and calculation of value in use

IE23 At the end of 20X0, entity T acquires entity M for CU10,000. M has manufacturing plants in three countries.

Schedule 1. Data at the end of 20X0

<i>End of 20X0</i>	<i>Allocation of purchase price</i>	<i>Fair value of identifiable assets</i>	<i>Goodwill^(a)</i>
	CU	CU	CU ^(a)
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	<u>5,000</u>	<u>3,500</u>	<u>1,500</u>
Total	<u>10,000</u>	<u>7,000</u>	<u>3,000</u>

(a) Activities in each country represent the lowest level at which the goodwill is monitored for internal management purposes (determined as the difference between the purchase price of the activities in each country, as specified in the purchase agreement, and the fair value of the identifiable assets).

IE23A Because goodwill has been allocated to the activities in each country, each of those activities must be tested for impairment annually or more frequently if there is any indication that it may be impaired (see paragraph 90 of IAS 36).

IE24 The recoverable amounts (ie higher of value in use and fair value less costs of disposal) of the cash-generating units are determined on the basis of value in use calculations. At the end of 20X0 and 20X1, the value in use of each cash-generating unit exceeds its carrying amount. Therefore the activities in each country and the goodwill allocated to those activities are regarded as not impaired.

IE25 At the beginning of 20X2, a new government is elected in Country A. It passes legislation significantly restricting exports of T's main product. As a result, and for the foreseeable future, T's production in Country A will be cut by 40 per cent.

IE26 The significant export restriction and the resulting production decrease require T also to estimate the recoverable amount of the Country A operations at the beginning of 20X2.

IE27 T uses straight-line depreciation over a 12-year life for the Country A identifiable assets and anticipates no residual value.

Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the beginning of 20X2

<i>Beginning of 20X2</i>	<i>Goodwill</i>	<i>Identifiable assets</i>	<i>Total</i>
	CU	CU	CU
Historical cost	1,000	2,000	3,000
Accumulated depreciation (20X1)	-	(167)	(167)
Carrying amount	1,000	1,833	2,833
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	-	1,360	1,360

Example 3 Deferred tax effects

A - Deferred tax effects of the recognition of an impairment loss

Use the data for entity T as presented in Example 2, with supplementary information as provided in this example.

- IE33 At the beginning of 20X2, the tax base of the identifiable assets of the Country A cash-generating unit is CU900. Impairment losses are not deductible for tax purposes. The tax rate is 40 per cent.
- IE34 The recognition of an impairment loss on the assets of the Country A cash-generating unit reduces the taxable temporary difference related to those assets. The deferred tax liability is reduced accordingly.

<i>Beginning of 20X2</i>	<i>Identifiable assets before impairment loss</i>	<i>Impairment loss</i>	<i>Identifiable assets after impairment loss</i>
	CU	CU	CU
Carrying amount (Example 2)	1,833	(473)	1,360
Tax base	900	-	900
Taxable temporary difference	933	(473)	460
Deferred tax liability at 40%	373	(189)	184

- IE35 In accordance with IAS 12 *Income Taxes*, no deferred tax relating to the goodwill was recognised initially. Therefore, the impairment loss relating to the goodwill does not give rise to a deferred tax adjustment.

HKAS 37
Revised September 2018~~November 2016~~

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets



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Hong Kong Accounting Standard 37 *Provisions, Contingent Liabilities and Contingent Assets* (HKAS 37) is set out in paragraphs 1-101~~96~~. All the paragraphs have equal authority. HKAS 37 should be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Scope

- 1 **This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:**
 - (a) **those resulting from executory contracts, except where the contract is onerous; and**
 - (b) [deleted]
 - (c) **those covered by another Standard.**
- 2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of HKFRS 9 *Financial Instruments* ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~.
- 3 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.
- 4 [Deleted]
- 5⁺ When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, some types of provisions are addressed in Standards on:
 - (a) ~~[deleted] construction contracts (see HKAS 11 *Construction Contracts*);~~
 - (b) income taxes (see HKAS 12 *Income Taxes*);
 - (c) leases (see HKAS 17 *Leases*). However, as HKAS 17 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases;
 - (d) employee benefits (see HKAS 19 *Employee Benefits*);
 - (e) insurance contracts (see HKFRS 4 *Insurance Contracts*). However, this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of HKFRS 4; ~~and~~
 - (f) contingent consideration of an acquirer in a business combination (see HKFRS 3 *Business Combinations*); ~~and~~
 - (g) revenue from contracts with customers (see HKFRS 15 *Revenue from Contracts with Customers*). However, as HKFRS 15 contains no specific requirements to address contracts with customers that are, or have become, onerous, this Standard applies to such cases.

⁺ ~~Amendments effective for annual periods beginning on or after 1 July 2009.~~

- 6 ~~[Deleted] Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. HKAS 18 Revenue identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of HKAS 18.~~
- 7 This Standard defines provisions as liabilities of uncertain timing or amount. In some countries the term "provision" is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.

Contingent assets

- 31 An entity shall not recognise a contingent asset.**
- 32 Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.
- 33 Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- 34 A contingent asset is disclosed, as required by paragraph 89, where an inflow of economic benefits is probable.
- 35 Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset (see paragraph 89).

Measurement

Best estimate

- 36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.**
- 37 The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- 38 The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting period.
- 39 Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value". The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

- 97 [Not used]
- 98 [Not used]
- 99 *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraph 5 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.
- 100 HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 5 and deleted paragraph 6. An entity shall apply those amendments when it applies HKFRS 15.
- 101 HKFRS 9, as issued in September 2014, amended paragraph 2 and deleted paragraphs 97 and 98. An entity shall apply those amendments when it applies HKFRS 9.

Example 8 An onerous contract

An entity operates profitably from a factory that it has leased under an operating lease. During December 20X0 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event - The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - When the lease becomes onerous, an outflow of resources embodying economic benefits is probable (Until the lease becomes onerous, the entity accounts for the lease under IAS 17 *Leases*).

Conclusion - A provision is recognised for the best estimate of the unavoidable lease payments (see paragraphs 5(c), 14 and 66).

Example 8A - An onerous contract

Same facts as example 8 except that the old factory can be used as a temporary godown generating a low level of income.

Conclusion - A provision is recognised for the best estimate of the net amount of the unavoidable lease costs i.e. the gross unavoidable lease costs less the probable net revenue expected from the godown operations (see paragraph 5(c), 14 and 66).

Example 9 A single guarantee

~~[Deleted] On 31 December 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1, the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.~~

~~This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*, but is within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*, because it also meets the definition of a financial guarantee contract in IAS 39. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts. IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits and that also complies with the requirements in IAS 39 for financial guarantee contracts within the scope of IAS 39.~~

~~(a) — At 31 December 20X0~~

~~**Present obligation as a result of a past obligating event** — The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~**An outflow of resources embodying economic benefits in settlement** — No outflow of benefits is probable at 31 December 20X0.~~

~~**Conclusion** — The guarantee is recognised at fair value.~~

~~(b) — At 31 December 20X1~~

~~**Present obligation as a result of a past obligating event** — The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~**An outflow of resources embodying economic benefits in settlement** — At 31 December 20X1, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.~~

~~**Conclusion** — The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 14 and 23), and (b) the amount initially recognised less, when appropriate, the cumulative amortisation amount of income recognised in accordance with IAS 18 *Revenue* the principles of IFRS 15 *Revenue from Contracts with Customers*.~~

HKAS 38
Revised ~~January 2017~~ September 2018

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 38

Intangible Assets



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Hong Kong Accounting Standard 38

Intangible Assets

Objective

- 1 The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Scope

- 2 **This Standard shall be applied in accounting for intangible assets, except:**
- (a) **intangible assets that are within the scope of another Standard;**
 - (b) **financial assets, as defined in HKAS 32 *Financial Instruments: Presentation*; and**
 - (c) **the recognition and measurement of exploration and evaluation assets (see HKFRS 6 *Exploration for and Evaluation of Mineral Resources*); and**
 - (d) **expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.**
- 3 If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard does not apply to:
- (a) intangible assets held by an entity for sale in the ordinary course of business (see HKAS 2 *Inventories* and ~~HKAS 11 *Construction Contracts*~~).
 - (b) deferred tax assets (see HKAS 12 *Income Taxes*).
 - (c) leases that are within the scope of HKAS 17 *Leases*.
 - (d) assets arising from employee benefits (see HKAS 19 *Employee Benefits*).
 - (e) financial assets as defined in HKAS 32. The recognition and measurement of some financial assets are covered by HKFRS 10 *Consolidated Financial Statements*, HKAS 27 *Separate Financial Statements* and HKAS 28 *Investments in Associates and Joint Ventures*.
 - (f) goodwill acquired in a business combination (see HKFRS 3 *Business Combinations*).
 - (g) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4 *Insurance Contracts*. HKFRS 4 sets out specific disclosure requirements for those deferred acquisition costs but not for those intangible assets. Therefore, the disclosure requirements in this Standard apply to those intangible assets.

- (h) non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.
 - (i) assets arising from contracts with customers that are recognised in accordance with HKFRS 15 *Revenue from Contracts with Customers*.
- 4 Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both intangible and tangible elements should be treated under HKAS 16 *Property, Plant and Equipment* or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant. For example, 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. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.
 - 5 This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.
 - 6 In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee accounts for an intangible asset held under a finance lease in accordance with this Standard. Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of HKAS 17 and are within the scope of this Standard.
 - 7 Exclusions from the scope of a Standard may occur if activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the accounting for expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. Therefore, this Standard does not apply to expenditure on such activities and contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

Definitions

- 8 The following terms are used in this Standard with the meanings specified:**

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Intangible assets with indefinite useful lives

- 107 An intangible asset with an indefinite useful life shall not be amortised.**
- 108 In accordance with HKAS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount
- (a) annually, and
 - (b) whenever there is an indication that the intangible asset may be impaired.

Review of useful life assessment

- 109 The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with HKAS 8.**
- 110 In accordance with HKAS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with HKAS 36, with its carrying amount, and recognising any excess of the carrying amount over the recoverable amount as an impairment loss.

Recoverability of the carrying amount - impairment losses

- 111 To determine whether an intangible asset is impaired, an entity applies HKAS 36. That Standard explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

Retirements and disposals

- 112 An intangible asset shall be derecognised:**
- (a) on disposal; or
 - (b) when no future economic benefits are expected from its use or disposal.
- 113 **The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognised in profit or loss when the asset is derecognised (unless HKAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.**
- 114 The disposal of an intangible asset may occur in a variety of ways (eg by sale, by entering into a finance lease, or by donation). ~~In determining the date of disposal of such an asset, an entity applies the criteria in HKAS 18 Revenue for recognising revenue from the sale of goods~~ an intangible asset is the date that the recipient obtains control of that asset in accordance with the requirements for determining when a performance obligation is satisfied in HKFRS 15. HKAS 17 applies to disposal by a sale and leaseback.

- 115 If in accordance with the recognition principle in paragraph 21 an entity recognises in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognises the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.
- 115A In the case of a reacquired right in a business combination, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, shall be used in determining the gain or loss on reissue.
- 116 ~~The amount of consideration receivable on disposal to be included in the gain or loss arising from the derecognition of an intangible asset is recognised initially at its fair value. If payment for the intangible asset is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 reflecting the effective yield on the receivable determined in accordance with the requirements for determining the transaction price in paragraphs 47–72 of HKFRS 15. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in HKFRS 15.~~
- 117 Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5.

Disclosure

General

- 118 **An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:**
- (a) **whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;**
 - (b) **the amortisation methods used for intangible assets with finite useful lives;**
 - (c) **the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;**
 - (d) **the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;**
 - (e) **a reconciliation of the carrying amount at the beginning and end of the period showing:**
 - (i) **additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;**
 - (ii) **assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;**

- 130A An entity shall apply the amendments in paragraph 2 for annual periods beginning on or after 1 January 2006. If an entity applies HKFRS 6 for an earlier period, those amendments shall be applied for that earlier period.
- 130B HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 85, 86 and 118(e)(iii). An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 130C HKFRS 3 (as revised in 2008) amended paragraphs 12, 33-35, 68, 69, 94 and 130, deleted paragraphs 38 and 129 and added paragraph 115A. *Improvements to HKFRSs* issued in May 2009 amended paragraphs 36 and 37. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 July 2009. Therefore, amounts recognised for intangible assets and goodwill in prior business combinations shall not be adjusted. If an entity applies HKFRS 3 (revised 2008) for an earlier period, it shall apply the amendments for that earlier period and disclose the fact.
- 130D Paragraphs 69, 70 and 98 were amended and paragraph 69A was added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 130E [Deleted]
- 130F HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraph 3(e). An entity shall apply that amendment when it applies HKFRS 10 and HKFRS 11.
- 130G HKFRS 13, issued in June 2011, amended paragraphs 8, 33, 47, 50, 75, 78, 82, 84, 100 and 124 and deleted paragraphs 39-41 and 130E. An entity shall apply those amendments when it applies HKFRS 13.
- 130H *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraph 80. An entity shall apply that amendment for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 130I An entity shall apply the amendment made by *Annual Improvements to HKFRSs 2010–2012 Cycle* to all revaluations recognised in annual periods beginning on or after the date of initial application of that amendment and in the immediately preceding annual period. An entity may also present adjusted comparative information for any earlier periods presented, but it is not required to do so. If an entity presents unadjusted comparative information for any earlier periods, it shall clearly identify the information that has not been adjusted, state that it has been presented on a different basis and explain that basis.
- 130J *Clarification of Acceptable Methods of Depreciation and Amortisation* (Amendments to HKAS 16 and HKAS 38), issued in June 2014, amended paragraphs 92 and 98 and added paragraphs 98A–98C. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.
- 130K HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 3, 114 and 116. An entity shall apply those amendments when it applies HKFRS 15.

*Basis for Conclusions on
Hong Kong Accounting Standard 38*

Intangible Assets



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Dissent of Mary Tokar from Clarification of Acceptable Methods of Depreciation and Amortisation (Amendments to IAS 16 and IAS 38) as issued in May 2014

DO1 Ms Tokar is dissenting from the publication of this amendment. She does not object to the IASB's objective of clarifying acceptable methods of depreciation and amortisation, nor to its conclusions to preclude revenue-based depreciation and nor to the introduction of a rebuttable presumption that revenue cannot be used as a basis for amortisation of intangibles. She also agrees that expectations of obsolescence should be considered when determining the useful life of an asset and selecting an amortisation or depreciation method that reflects the pattern of consumption of the asset. However, she is concerned that the amendments will not fully resolve the practice issue that was originally raised with the IFRS Interpretations Committee. She believes that the amendments are not sufficiently clear regarding what evidence is required to overcome the presumption and instead support the use of revenue as the basis for amortisation of an intangible asset. She believes that further guidance should be included to explain when the pattern of consumption of economic benefits is the same as the pattern in which revenue is generated.

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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IMPLEMENTATION GUIDANCE

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 12-109-110 and Appendices A and -B. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

The HKICPA decided to replace HKAS 39 *Financial Instruments: Recognition and Measurement* over a period of time. The first instalment, dealing with classification and measurement of financial assets, was issued as HKFRS 9 *Financial Instruments* in November 2009. The requirements for classification and measurement of financial liabilities and derecognition of financial assets and liabilities were added to HKFRS 9 in November 2010. Requirements for hedge accounting were added to HKFRS 9 in December 2013. The requirements for classification and measurement of financial assets were amended and the requirements for amortised cost measurement and impairment were added in September 2014. The International Accounting Standards Board is deliberating proposals on accounting for macro hedging and in April 2014 published a Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.

Reasons for issuing HKAS 39

- IN1 — ~~Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted.~~
- IN2 — ~~The objectives of the Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 39 were to deal with some convergence issues and to make other improvements.~~
- IN3 — ~~HKAS 39 establishes principles for recognising and measuring financial assets and financial liabilities and provides additional guidance on selected matters such as derecognition, when financial assets and financial liabilities may be measured at fair value, how to assess impairment, how to determine fair value and some aspects of hedge accounting.~~

The main features

- IN4 — ~~The main features of HKAS 39 are described below.~~

Scope

- IN5 — ~~The Standard provides certain scope exclusions. A scope exclusion has been made for loan commitments that are not designated as at fair value through profit or loss, cannot be settled net, and do not involve a loan at a below market interest rate. A commitment to provide a loan at a below market interest rate is initially recognised at fair value, and subsequently measured at the higher of (a) the amount that would be recognised in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, when appropriate, the cumulative amortisation amount of income recognised in accordance with HKAS 18 *Revenue* the principles of HKFRS 15 *Revenue from Contracts with Customers*.~~
- IN6 — ~~The scope of the Standard includes financial guarantee contracts issued. However, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 *Insurance Contracts* to such financial guarantee contracts. Under this Standard, a financial guarantee contract is initially recognised at fair value and is subsequently measured at the higher of (a) the amount determined in accordance with HKAS 37 and (b) the amount~~

~~initially recognised less, when appropriate, the cumulative amortisation amount of income recognised in accordance with HKAS 18 the principles of HKFRS 15. Different requirements apply for the subsequent measurement of financial guarantee contracts that prevent derecognition of financial assets or result in continuing involvement. Financial guarantee contracts held are not within the scope of the Standard because they are insurance contracts and are therefore outside the scope of the Standard because of the general scope exclusion for such contracts.~~

~~IN7—The Standard requires that a contract to buy or sell a non-financial item is within the scope of HKAS 39 if it can be settled net in cash or another financial instrument, unless it is entered into and continues to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, the Standard states that there are various ways in which a contract to buy or sell a non-financial asset can be settled net. These include: when the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments; when the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and when the non-financial item that is the subject of the contract is readily convertible to cash. The Standard also states that a written option that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of the Standard.~~

Definitions

~~IN8—HKAS 39 provides definitions of four categories of financial instruments. Under HKAS 39, an entity is permitted to classify as loans and receivables purchased loans that are not quoted in an active market.~~

Reclassifications

~~IN8A—An amendment to the Standard, issued in October 2008, permits an entity to reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in particular circumstances. The amendment also permits an entity to transfer from the available-for-sale category to the loans and receivables category a financial asset that would have met the definition of loans and receivables (if the financial asset had not been designated as available-for-sale), if the entity has the intention and ability to hold that financial asset for the foreseeable future. A further amendment, issued in November 2008, clarified the effective date and transition requirements of that earlier amendment.~~

Derecognition of a financial asset

~~IN9—Under HKAS 39, several concepts governed when a financial asset should be derecognised and two of which are the concepts of *risks and rewards* and *control*. The Standard states that the evaluation of the transfer of risks and rewards of ownership precedes the evaluation of the transfer of control for all derecognition transactions.~~

~~IN10—Under the Standard, an entity determines what asset is to be considered for derecognition. The Standard requires a part of a larger financial asset to be considered for derecognition if, and only if, the part is one of:~~

~~(a)—specifically identified cash flows from a financial asset; or~~

- ~~(b) — a fully proportionate (pro rata) share of the cash flows from a financial asset; or~~
- ~~(c) — a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset.~~

~~In all other cases, the Standard requires the financial asset to be considered for derecognition in its entirety.~~

~~IN11 — The Standard introduces the notion of a ‘transfer’ of a financial asset. A financial asset is derecognised when (a) an entity has transferred a financial asset and (b) the transfer qualifies for derecognition.~~

~~IN12 — The Standard states that an entity has transferred a financial asset if, and only if, it either:~~

- ~~(a) — retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets three specified conditions; or~~
- ~~(b) — transfers the contractual rights to receive the cash flows of a financial asset.~~

~~IN13 — Under the Standard, if an entity has transferred a financial asset, it assesses whether it has transferred substantially all the risks and rewards of ownership of the transferred asset. If an entity has retained substantially all such risks and rewards, it continues to recognise the transferred asset. If it has transferred substantially all such risks and rewards, it derecognises the transferred asset.~~

~~IN14 — The Standard specifies that if an entity has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred asset, it assesses whether it has retained control over the transferred asset. If it has retained control, the entity continues to recognise the transferred asset to the extent of its continuing involvement in the transferred asset. If it has not retained control, the entity derecognises the transferred asset.~~

~~IN15 — The Standard provides guidance on how to apply the concepts of risks and rewards and of control.~~

Measurement: fair value option

~~IN16 — An amendment to the Standard, issued in July 2005, permits an entity to designate a financial asset or financial liability (or a group of financial assets, financial liabilities or both) on initial recognition as one(s) to be measured at fair value, with changes in fair value recognised in profit or loss. To impose discipline on this categorisation, an entity is precluded from reclassifying financial instruments into or out of this category.~~

~~IN17 — [Not used]~~

~~—— [Deleted]~~

~~—— [Deleted]~~

Impairment of financial assets

~~IN20 — The Standard states that an impairment loss is recognised only when it has been incurred. It also provides certain guidance on what events provide objective evidence of impairment for investments in equity instruments.~~

~~IN21—The Standard provides certain guidance about how to evaluate impairment that is inherent in a group of loans, receivables or held-to-maturity investments, but cannot yet be identified with any individual financial asset in the group, as follows:~~

- ~~• An asset that is individually assessed for impairment and found to be impaired should not be included in a group of assets that are collectively assessed for impairment.~~
- ~~• An asset that has been individually assessed for impairment and found not to be individually impaired should be included in a collective assessment of impairment. The occurrence of an event or a combination of events should not be a precondition for including an asset in a group of assets that are collectively evaluated for impairment.~~
- ~~• When performing a collective assessment of impairment, an entity groups assets by similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms.~~
- ~~• Contractual cash flows and historical loss experience provide the basis for estimating expected cash flows. Historical loss rates are adjusted on the basis of relevant observable data that reflect current economic conditions.~~
- ~~• The methodology for measuring impairment should ensure that an impairment loss is not recognised on the initial recognition of an asset.~~

~~IN22—The Standard requires that impairment losses on available-for-sale equity instruments cannot be reversed through profit or loss, ie any subsequent increase in fair value is recognised in other comprehensive income.~~

Hedge accounting

~~IN23—Hedges of firm commitments are treated as fair value hedges rather than cash flow hedges. However, the Standard states that a hedge of the foreign currency risk of a firm commitment can be treated as either a cash flow hedge or a fair value hedge.~~

~~IN24—The Standard requires that when a hedged forecast transaction occurs and results in the recognition of a *financial* asset or a *financial* liability, the gain or loss recognised in other comprehensive income does not adjust the initial carrying amount of the asset or liability (ie basis adjustment is prohibited), but remains in equity and is reclassified from equity to profit or loss consistently with the recognition of gains and losses on the asset or liability as a reclassification adjustment. For hedges of forecast transactions that result in the recognition of a *non-financial* asset or a *non-financial* liability, the entity has a choice of whether to apply basis adjustment or retain the hedging gain or loss in equity and reclassify it from equity to profit or loss when the asset or liability affects profit or loss as a reclassification adjustment.~~

~~IN24A—This Standard permits fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk than previous versions of HKAS 39. In particular, for such a hedge, it allows:~~

- ~~(a) the hedged item to be designated as an amount of a currency (eg an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities).~~
- ~~(b) the gain or loss attributable to the hedged item to be presented either:~~

- ~~(i) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or~~
- ~~(ii) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.~~
- ~~(e) prepayment risk to be incorporated by scheduling prepayable items into repricing time periods based on expected, rather than contractual, repricing dates. However, when the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates are included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.~~

~~IN24B In 2008 the HKICPA amended the Standard, by *Eligible Hedged Items*, to clarify how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations.~~

Disclosure

~~IN25 [Not used]~~

Amendments to and withdrawal of other pronouncements

~~IN26 [Not used]~~

Potential impact of proposals in exposure drafts

~~IN27 [Deleted]~~

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

Objective

- 1 ~~[Deleted]The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in HKAS 32 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in HKFRS 7 *Financial Instruments: Disclosures*.~~

Scope

- 2 This Standard shall be applied by all entities to all ~~types of~~ financial instruments within the scope of HKFRS 9 *Financial Instruments* if, and to the extent that;~~except:~~
- (a) HKFRS 9 permits the hedge accounting requirements of this Standard to be applied; and those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with HKFRS 10 *Consolidated Financial Statements*, HKAS 27 *Separate Financial Statements* or HKAS 28 *Investments in Associates and Joint Ventures*. ~~However, in some cases, HKFRS 10, HKAS 27 or HKAS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in HKAS 32.~~
- (b) the financial instrument is part of a hedging relationship that qualifies for hedge accounting in accordance with this Standard.~~rights and obligations under leases to which HKAS 17 *Leases* applies. However:~~
- (i) ~~lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15-37, 58, 59, 63-65 and Appendix A paragraphs AG36-AG52 and AG84-AG93);~~
- (ii) ~~finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63); and~~
- (iii) ~~derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).~~
- (c) ~~employers' rights and obligations under employee benefit plans, to which HKAS 19 *Employee Benefits* applies.~~
- (d) ~~financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with~~

~~paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.~~

- ~~(e) — rights and obligations arising under (i) an insurance contract as defined in HKFRS 4 *Insurance Contracts* other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract that is within the scope of HKFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of HKFRS 4 if the derivative is not itself a contract within the scope of HKFRS 4 (see paragraphs 10–13 and Appendix A paragraphs AG27–AG33 of this standard). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.~~
- ~~(f) — [deleted]~~
- ~~(g) — any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of HKFRS 3 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.~~
- ~~(h) — loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15–42 and Appendix A paragraphs AG36–AG63).~~
- ~~(i) — financial instruments, contracts and obligations under share-based payment transactions to which HKFRS 2 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies.~~
- ~~(j) — rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance with HKAS 37, or for which, in an earlier period, it recognised a provision in accordance with HKAS 37.~~
- ~~(k) — rights and obligations within the scope of HKFRS 15 *Revenue from Contracts with Customers* that are financial instruments, except for those that HKFRS 15 specifies are accounted for in accordance with HKFRS 9.~~

~~2A-7 [Deleted] The impairment requirements of this Standard shall be applied to those rights that HKFRS 15 specifies are accounted for in accordance with this Standard for the purposes of recognising impairment losses.~~

~~4 The following loan commitments are within the scope of this Standard:—~~

- ~~(a) loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.—~~
- ~~(b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).—~~
- ~~(c) commitments to provide a loan at a below market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.—~~

~~5 This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.~~

~~6 There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:—~~

- ~~(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;—~~
- ~~(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);—~~
- ~~(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin; and—~~
- ~~(d) when the non-financial item that is the subject of the contract is readily convertible to cash.—~~

~~A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.—~~

~~7 A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with~~

~~paragraph 6(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.~~

Definitions

8 The terms defined in HKFRS 13, HKFRS 9 and HKAS 32 are used in this Standard with the meanings specified in Appendix A of HKFRS 13, Appendix A of HKFRS 9 and paragraph 11 of HKAS 32. HKFRS 13, HKFRS 9 and HKAS 32 defines the following terms:

- amortised cost of a financial asset or financial liability
- derecognition
- derivative
- effective interest method
- effective interest rate
- equity instrument
- fair value
- ~~financial instrument~~
- financial asset
- ~~financial liability~~
- ~~equity instrument~~
- financial instrument
- financial liability

and provides guidance on applying those definitions.

9 The following terms are used in this Standard with the meanings specified:

~~Definition of a derivative~~

~~A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-7) with all three of the following characteristics:~~

- ~~(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');~~
- ~~(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and~~
- ~~(c) it is settled at a future date.~~

~~Definitions of four categories of financial instruments~~

~~A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets any of the following conditions.~~

- ~~(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if:~~
 - ~~(i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;~~
 - ~~(ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is~~

~~evidence of a recent actual pattern of short-term profit-taking; or~~

~~(iii) — it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).~~

~~(aa) — It is contingent consideration of an acquirer in a business combination to which HKFRS 3 *Business Combinations* applies.~~

~~(b) — Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either~~

~~(i) — it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or~~

~~(ii) — a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in HKAS 24 *Related Party Disclosures*), for example the entity’s board of directors and chief executive officer.~~

~~In HKFRS 7, paragraphs 9–11 and B4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity’s documented risk management or investment strategy.~~

~~Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.~~

~~It should be noted that HKFRS 13 *Fair Value Measurement* sets out the requirements for measuring the fair value of a financial asset or financial liability, whether by designation or otherwise, or whose fair value is disclosed.~~

~~*Held-to-maturity investments* are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG16–AG25) other than:~~

~~(a) — those that the entity upon initial recognition designates as at fair value through profit or loss;~~

~~(b) — those that the entity designates as available for sale; and~~

~~(c) — those that meet the definition of loans and receivables.~~

~~An entity shall not classify any financial assets as held-to-maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments~~

~~before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:~~

- ~~(i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;~~
- ~~(ii) occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or~~
- ~~(iii) are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.~~

~~Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:~~

- ~~(a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;~~
- ~~(b) those that the entity upon initial recognition designates as available for sale; or~~
- ~~(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.~~

~~An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.~~

~~Available for sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.~~

Definition of a financial guarantee contract

~~A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.~~

Definitions relating to recognition and measurement

~~The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.~~

~~The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future~~

~~cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see HKAS 18 Revenue paragraphs AG8A-AG8B), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).~~

~~*Derecognition* is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.~~

~~Dividends are distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.~~

~~*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13)~~

~~*A regular way purchase or sale* is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.~~

~~*Transaction costs* are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.~~

Definitions relating to hedge accounting

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72-77 and Appendix A paragraphs AG94-AG97 elaborate on the definition of a hedging instrument).

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 78-84 and Appendix A paragraphs AG98-AG101 elaborate on the definition of hedged items).

Hedge effectiveness is the degree to which changes in the fair value or cash flows of

the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113A).

Embedded derivatives

~~10- [Deleted]~~

~~70 An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.~~

~~11 An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:~~

- ~~(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);~~
- ~~(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and~~
- ~~(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).~~

~~If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.~~

~~11A Notwithstanding paragraph 11, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:~~

- ~~(a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or~~
- ~~(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.~~

- ~~12 — If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.~~
- ~~13 — If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an equity instrument that does not have a quoted price in an active market for an identical instrument, ie a Level 1 input), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 12 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.~~

~~Recognition and derecognition~~

~~Initial recognition~~

- ~~14 — An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)~~

~~Derecognition of a financial asset~~

- ~~15 — In consolidated financial statements, paragraphs 16-23 and Appendix A paragraphs AG34-AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with HKFRS 10 and then applies paragraphs 16-23 and Appendix A paragraphs AG34-AG52 to the resulting group.~~
- ~~16 — Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.~~
- ~~(a) — Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.~~
- ~~(i) — The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.~~
- ~~(ii) — The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement~~

~~whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 17-23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.~~

~~(iii) — The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.~~

~~(b) — In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.~~

~~In paragraphs 17-26, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.~~

~~17 — An entity shall derecognise a financial asset when, and only when:~~

- ~~(a) — the contractual rights to the cash flows from the financial asset expire; or~~
- ~~(b) — it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.~~

~~—— (See paragraph 38 for regular way sales of financial assets.)~~

~~18 — An entity transfers a financial asset if, and only if, it either:~~

- ~~(a) — transfers the contractual rights to receive the cash flows of the financial asset; or~~
- ~~(b) — retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.~~

~~19 — When an entity retains the contractual rights to receive the cash flows of a financial asset (the ‘original asset’), but assumes a contractual obligation to pay those cash flows to one or more entities (the ‘eventual recipients’), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.~~

- (a) ~~The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.~~
- (b) ~~The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.~~
- (c) ~~The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in HKAS 7 *Statement of Cash Flows*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.~~
- 20 ~~When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:—~~
- (a) ~~if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.~~
- (b) ~~if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.~~
- (c) ~~if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:—~~
- (i) ~~if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.~~
- (ii) ~~if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 30).~~
- 21 ~~The transfer of risks and rewards (see paragraph 20) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 19).~~

~~22 — Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.~~

~~23 — Whether the entity has retained control (see paragraph 20(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.~~

~~Transfers that qualify for derecognition (see paragraph 20(a) and (c)(i))~~

~~24 — If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 27.~~

~~25 — If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.~~

~~26 — On derecognition of a financial asset in its entirety, the difference between:~~

~~(a) — the carrying amount and~~

~~(b) — the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income (see paragraph 55(b))~~

~~shall be recognised in profit or loss.~~

~~27 — If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 16(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:~~

- ~~(a) — the carrying amount allocated to the part derecognised and—~~
- ~~(b) — the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))—~~

~~shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.—~~

- ~~28 — When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be measured. When the entity has a history of selling parts similar to the part that continues to be recognised or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.—~~

~~Transfers that do not qualify for derecognition (see paragraph 20(b))—~~

- ~~29 — If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.—~~

~~Continuing involvement in transferred assets (see paragraph 20(c)(ii))—~~

- ~~30 — If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:—~~

- ~~(a) — when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').—~~
- ~~(b) — when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG48).—~~
- ~~(c) — when the entity's continuing involvement takes the form of a cash settled~~

~~option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.~~

~~31 When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:~~

~~(a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or~~

~~(b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.~~

~~32 The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.~~

~~33 For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 55, and shall not be offset.~~

~~34 If an entity's continuing involvement is in only a part of a financial asset (eg when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:~~

~~(a) the carrying amount allocated to the part that is no longer recognised; and~~

~~(b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))~~

~~shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.~~

~~35 If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.~~

~~All transfers—~~

- ~~36—If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see HKAS 32 paragraph 42).—~~
- ~~37—If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:—~~
- ~~(a)—If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.—~~
 - ~~(b)—If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.—~~
 - ~~(c)—If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.—~~
 - ~~(d)—Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.—~~

~~Regular way purchase or sale of a financial asset—~~

- ~~38—A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG53–AG56).—~~

~~Derecognition of a financial liability—~~

- ~~39—An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.—~~
- ~~40—An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.—~~
- ~~41—The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the~~

~~consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.~~

- 42 — If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

Measurement

Initial measurement of financial assets and financial liabilities

- 43 — ~~When~~Except for trade receivables within the scope of paragraph 44A, when a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

- 43A — ~~However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph AG76.~~

- 44 — ~~When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see Appendix A paragraphs AG53–AG56).~~

- 44A — Notwithstanding the requirement in paragraph 43, at initial recognition, an entity shall measure trade receivables that do not have a significant financing component (determined in accordance with HKFRS 15) at their transaction price (which is defined in HKFRS 15).

Subsequent measurement of financial assets

- 45 — ~~For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 9:~~

- ~~(a) — financial assets at fair value through profit or loss;~~
- ~~(b) — held-to-maturity investments;~~
- ~~(c) — loans and receivables; and~~
- ~~(d) — available-for-sale financial assets.~~

~~These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information in the financial statements. The entity shall disclose in the notes the information required by HKFRS 7.~~

- 46 — ~~After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following~~

~~financial assets:—~~

- ~~(a) — loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;—~~
- ~~(b) — held to maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and—~~
- ~~(c) — investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).—~~

~~Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89–102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58–70 and Appendix A paragraphs AG84–AG93.—~~

~~Subsequent measurement of financial liabilities—~~

~~47 — After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:—~~

- ~~(a) — financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) whose fair value cannot otherwise be reliably measured, which shall be measured at cost.—~~
- ~~(b) — financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities—~~
- ~~(c) — financial guarantee contracts as defined in paragraph 9. After initial recognition, an issuer of such a contract shall (unless paragraph 47(a) or (b) applies) measure it at the higher of:

 - ~~(i) — the amount determined in accordance with HKAS 37; and—~~
 - ~~(ii) — the amount initially recognised (see paragraph 43) less, when appropriate, the cumulative amortisation amount of income recognised in accordance with HKAS 18 the principles of HKFRS 15.—~~~~
- ~~(d) — commitments to provide a loan at a below market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 47(a) applies) measure it at the higher of:—

 - ~~(i) — the amount determined in accordance with HKAS 37; and~~
 - ~~(ii) — the amount initially recognised (see paragraph 43) less, when~~~~

~~appropriate, the cumulative amortisation amount of income recognised in accordance with HKAS 18 the principles of HKFRS 15.~~

~~Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 89–102.~~

~~48–49 [Deleted]~~

~~Reclassifications~~

~~50 An entity:~~

- ~~(a) shall not reclassify a derivative out of the fair value through profit or loss category while it is held or issued;~~
- ~~(b) shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss; and~~
- ~~(c) may, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through profit or loss category if the requirements in paragraph 50B or 50D are met.~~

~~An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.~~

~~50A The following changes in circumstances are not reclassifications for the purposes of paragraph 50:~~

- ~~(a) a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;~~
- ~~(b) a derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge;~~
- ~~(c) financial assets are reclassified when an insurance company changes its accounting policies in accordance with paragraph 45 of HKFRS 4.~~

~~50B A financial asset to which paragraph 50(c) applies (except a financial asset of the type described in paragraph 50D) may be reclassified out of the fair value through profit or loss category only in rare circumstances.~~

~~50C If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.~~

~~50D A financial asset to which paragraph 50(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through profit or loss category if the entity has the intention and ability to hold the financial asset for the~~

foreseeable future or until maturity.

- 50E—A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available for sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
- 50F—~~If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50D or out of the available for sale category in accordance with paragraph 50E, it shall reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 50D, any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable. For a financial asset reclassified out of the available for sale category in accordance with paragraph 50E, any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for in accordance with paragraph 54.~~
- 51—~~If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).—~~
- 52—~~Whenever sales or reclassification of more than an insignificant amount of held to maturity investments do not meet any of the conditions in paragraph 9, any remaining held to maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).—~~
- 53—~~If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 46(c) and 47), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.—~~
- 54—~~If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 46(c) and 47) or because the ‘two preceding financial years’ referred to in paragraph 9 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for as follows:—~~
- (a)—~~In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held to maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss in accordance with paragraph 67.—~~

- (b) ~~In the case of a financial asset that does not have a fixed maturity, the gain or loss shall be recognised in profit or loss when the financial asset is sold or otherwise disposed of. If the financial asset is subsequently impaired any previous gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss in accordance with paragraph 67.~~

~~Gains and losses~~

~~55 A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 89–102), shall be recognised, as follows.~~

- (a) ~~A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.~~
- (b) ~~A gain or loss on an available for sale financial asset shall be recognised in other comprehensive income, except for impairment losses (see paragraphs 67–70) and foreign exchange gains and losses (see Appendix A paragraph AG83), until the financial asset is derecognised. At that time, the cumulative gain or loss previously recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 *Presentation of Financial Statements* (as revised in 2007)). However, interest calculated using the effective interest method (see paragraph 9) is recognised in profit or loss (see HKAS 18). Dividends on an available for sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see HKAS 18) in accordance with paragraph 55A.~~

~~55A Dividends are recognised in profit or loss only when:~~

- (a) ~~the entity's right to receive payment of the dividend is established;~~
- (b) ~~it is probable that the economic benefits associated with the dividend will flow to the entity; and~~
- (c) ~~the amount of the dividend can be measured reliably.~~

~~56 For financial assets and financial liabilities carried at amortised cost (see paragraphs 46 and 47), a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 78–84 and Appendix A paragraphs AG98–AG101) the accounting for the gain or loss shall follow paragraphs 89–102.~~

~~57 If an entity recognises financial assets using settlement date accounting (see paragraph 38 and Appendix A paragraphs AG53 and AG56), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 55.~~

~~Impairment and uncollectibility of financial assets~~

~~58 — An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available for sale financial assets) to determine the amount of any impairment loss.~~

~~59 — A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:~~

- ~~(a) — significant financial difficulty of the issuer or obligor;~~
- ~~(b) — a breach of contract, such as a default or delinquency in interest or principal payments;~~
- ~~(c) — the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;~~
- ~~(d) — it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;~~
- ~~(e) — the disappearance of an active market for that financial asset because of financial difficulties; or~~
- ~~(f) — observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:~~
 - ~~(i) — adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or~~
 - ~~(ii) — national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).~~

~~60 — The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit~~

~~rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).~~

~~61 In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.~~

~~62 In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.~~

~~Financial assets carried at amortised cost~~

~~63 If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.~~

~~64 An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.~~

~~65 If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.~~

~~Financial assets carried at cost~~

- ~~66 If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed.~~

~~Available for sale financial assets~~

- ~~67 When a decline in the fair value of an available for sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognised.~~
- ~~68 The amount of the cumulative loss that is reclassified from equity to profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.~~
- ~~69 Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.~~
- ~~70 If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss.~~

Hedging

- 71 If an entity applies HKFRS 9 and has not chosen as its accounting policy to continue to apply the hedge accounting requirements of this Standard (see paragraph 7.2.1921 of HKFRS 9), it shall apply the hedge accounting requirements in Chapter 6 of HKFRS 9. However, for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, an entity may, in accordance with paragraph 6.1.3 of HKFRS 9, apply the hedge accounting requirements in this Standard instead of those in HKFRS 9. In that case the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114-AG132). If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 85-88 and Appendix A paragraphs AG102-AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89-102.

Hedging instruments

Qualifying instruments

- 72 This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 88 are met, except for some written options (see Appendix A paragraph AG94). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.
- 73 For hedge accounting purposes, only instruments that involve a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group provided that they are external to the individual entity that is being reported on.

Designation of hedging instruments

- 74 There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:
- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and
 - (b) separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

- 75 A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
- 76 A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.
- 77 Two or more derivatives, or proportions of them, (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (–for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net

written option.

Hedged items

Qualifying items

- 78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.
- 79 ~~[Deleted] Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.~~
- 80 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group, except for the consolidated financial statements of an investment entity, as defined in HKFRS 10, where transactions between an investment entity and its subsidiaries measured at fair value through profit or loss will not be eliminated in the consolidated financial statements. As an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with HKAS 21 *The Effects of Changes in Foreign Exchange Rates*. In accordance with HKAS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of financial items as hedged items

- 81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).
- 81A In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (eg an amount of dollars, euro, pounds or rand) rather

than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of non-financial items as hedged items

- 82 **If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.**

Designation of groups of items as hedged items

- 83 Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.
- 84 Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge accounting

- 85 Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.
- 86 **Hedging relationships are of three types:**
- (a) ***fair value hedge:* a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.**
 - (b) ***cash flow hedge:* a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.**

(c) *hedge of a net investment in a foreign operation as defined in HKAS 21.*

87 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

88 A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met.

- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
- (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113A) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
- (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
- (d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Fair value hedges

89 If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

- (a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with HKAS 21 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and
- (b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is a ~~an available-for-sale~~ financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9.

89A For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 89(b) may be met by presenting the gain or loss attributable to the hedged item either:

- (a) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or
- (b) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the statement of financial position when the assets or liabilities to which they relate are derecognised.

90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph ~~55~~5.7.1 of HKFRS 9.

91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:

- (a) **the hedging instrument expires or is sold, terminated or exercised. (For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:**
 - (i) **as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.**
 - (ii) **other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.**
- (b) **the hedge no longer meets the criteria for hedge accounting in paragraph 88; or**
- (c) **the entity revokes the designation.**

92 Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case

of a portfolio hedge of interest rate risk, to the separate line item in the statement of financial position described in paragraph 89A) shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

- 93 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The changes in the fair value of the hedging instrument are also recognised in profit or loss.
- 94 When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the statement of financial position.

Cash flow hedges

- 95 **If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:**
- (a) **the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and**
 - (b) **the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.**
- 96 More specifically, a cash flow hedge is accounted for as follows:
- (a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
 - (b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and
 - (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is

recognised in accordance with paragraph ~~55~~5.7.1 of HKFRS 9.

- 97 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in other comprehensive income in accordance with paragraph 95 shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (as revised in 2007)) in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment the amount that is not expected to be recovered.
- 98 If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:
- (a) It reclassifies the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95 to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.
 - (b) It removes the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.
- 99 An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.
- 100 For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in the same period or periods during which the hedged forecast cash flows affect profit or loss (for example, when a forecast sale occurs).
- 101 In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100:
- (a) The hedging instrument expires or is sold, terminated or exercised. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies. For the purpose of this subparagraph, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy. Additionally, for the purpose of this subparagraph there is not an expiration or termination of the hedging instrument if:

- (i) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.
 - (ii) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.
- (b) The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.
 - (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall be reclassified from equity to profit or loss as a reclassification adjustment. A forecast transaction that is no longer highly probable (see paragraph 88(c)) may still be expected to occur.
 - (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 97, 98 or 100 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment.

Hedges of a net investment

- 102 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see HKAS 21), shall be accounted for similarly to cash flow hedges:**
- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other

comprehensive income; and

- (b) the ineffective portion shall be recognised in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in accordance with paragraphs 48-49 of HKAS 21 on the disposal or partial disposal of the foreign operation.

Effective date and transitional provisions

- 103 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for annual periods beginning before 1 January 2005 unless it also applies HKAS 32. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact. Except as provided for in paragraphs 104 and 105 below, retrospective application is not permitted.
- 103A An entity shall apply the amendment in paragraph 2(j) for annual periods beginning on or after 1 January 2006. If an entity applies HK(IFRIC)-Int 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* for an earlier period, this amendment shall be applied for that earlier period.
- 103B ~~[Deleted] *Financial Guarantee Contracts* (Amendments to HKAS 39 and HKFRS 4), issued in September 2005, amended paragraphs 2(e) and (h), 4, 47 and AG4, added paragraph AG4A, added a new definition of financial guarantee contracts in paragraph 9, and deleted paragraph 3. An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 32^a and HKFRS 4 at the same time.~~
- 103C HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 26, 27, 34, 54, 55, 57, 67, 68, 95(a), 97, 98, 100, 102, 105, 108, AG4D, AG4E(d)(i), AG56, AG67, AG83 and AG99B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 103D ~~[Deleted] HKFRS 3 (as revised in 2008) deleted paragraph 2(f). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period. However, the amendment does not apply to contingent consideration that arose from a business combination for which the acquisition date preceded the application of HKFRS 3 (revised 2008). Instead, an entity shall account for such consideration in accordance with paragraphs 65A-65E of HKFRS 3 (as amended in 2010).~~
- 103E HKAS 27 (as amended in 2008) amended paragraph 102. An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendment shall be applied for that earlier period.
- 103F ~~[Deleted] An entity shall apply the amendment in paragraph 2 for annual periods beginning on or after 1 January 2009. If an entity applies *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1) issued~~

^a — When an entity applies HKFRS 7, the reference to HKAS 32 is replaced by a reference to HKFRS 7.

in June 2008, for an earlier period, the amendment in paragraph 2 shall be applied for that earlier period.

- 103G An entity shall apply paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B retrospectively for annual periods beginning on or after 1 July 2009, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies *Eligible Hedged Items* (Amendment to HKAS 39) for periods beginning before 1 July 2009, it shall disclose that fact.

103H- ~~[Deleted]~~

- ~~103J *Reclassification of Financial Assets* (Amendments to HKAS 39 and HKFRS 7), issued in October 2008, amended paragraphs 50 and AG8, and added paragraphs 50B–50F. An entity shall apply those amendments on or after 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B, 50D or 50E before 1 July 2008. Any reclassification of a financial asset made on or after 1 November 2008 shall take effect only from the date when the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B, 50D or 50E shall not be applied retrospectively before 1 July 2008.~~

- ~~103I *Reclassification of Financial Assets – Effective Date and Transition* (Amendments to HKAS 39 and HKFRS 7), issued in December 2008, amended paragraph 103H. An entity shall apply that amendment on or after 1 July 2008.~~

- ~~103J An entity shall apply paragraph 12, as amended by *Embedded Derivatives* (Amendments to HK(IFRIC)-Int 9 and HKAS 39), issued in March 2009, for annual periods ending on or after 30 June 2009.~~

- 103K *Improvements to HKFRSs* issued in May 2009 amended paragraphs 2(g), 97 and 100 and AG30(g). An entity shall apply the amendments to those paragraphs 2(g), 97 and 100 prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. An entity shall apply the amendment to paragraph AG30(g) for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

- ~~103L- [Deleted] *[These paragraphs refer to amendments that are not yet effective, and are therefore not*~~

- ~~103M *included in this edition.*~~
- ~~103N Paragraph 103D was amended by *Improvements to HKFRSs* issued in May 2010. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted.~~

- ~~103O *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*~~

- ~~103P HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 2(a), 15, AG3, AG36–AG38 and AG41(a). An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.~~

- 103Q HKFRS 13, issued in June 2011, amended paragraphs 9, 13, 28, 47, 88, AG46, AG52, AG64, AG76, AG76A, AG80, AG81 and AG96, added paragraph 43A and deleted paragraphs 48–49, AG69–AG75, AG77–AG79 and AG82. An entity shall apply those amendments when it applies HKFRS 13.

- 103R *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, amended paragraphs 2 and 80. An entity shall apply those amendments

for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.

103S ~~[Deleted]~~

103T HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 2, 9, 43, 47, 55, AG2, AG4 and AG48 and added paragraphs 2A, 44A, 55A and AG8A–AG8C. An entity shall apply those amendments when it applies HKFRS 15.

103U HKFRS 9, as issued in September 2014, amended paragraphs 2, 8, 9, 71, 89–90, 96, 104 AG95, AG114, AG118 and the headings above AG133 and deleted paragraphs 1, 2A, 4–7, 10–70, 103B, 103D, 103F, 103H–103J, 103L–103P, 103S, 105–107A, 108E–108F, AG1–AG93 and AG96. An entity shall apply those amendments when it applies HKFRS 9.

104 **The transition to this Standard should be as follows:**

(a) ~~—[not used]—~~

(b) for those transactions entered into before the beginning of the financial year in which this Standard is initially applied that the entity did previously designate as hedges, the recognition, derecognition, and measurement provisions of this Standard should be applied prospectively. Therefore, if the previously designated hedge does not meet the conditions for an effective hedge set out in paragraph 88 and the hedging instrument is still held, hedge accounting will no longer be appropriate starting with the beginning of the financial year in which this Standard is initially applied. Accounting in prior financial years should not be retrospectively changed to conform to the requirements of this Standard. Paragraphs 91 and 101 explain how to discontinue hedge accounting;

(c) ~~[Deleted]at the beginning of the financial year in which this Standard is initially applied, an entity should recognise all derivatives in its statement of financial position as either assets or liabilities and should measure them at fair value (except for a derivative that is linked to and that must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably). Because all derivatives, other than those that are designated hedging instruments, are considered held for trading, the difference between previous carrying amount (which may have been zero) and fair value of derivatives should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which this Standard is initially applied (other than for a derivative that is a designated hedging instrument);~~

(d) ~~[Deleted]at the beginning of the financial year in which this Standard is initially applied, an entity should apply the criteria in paragraphs 43–54 to identify those financial assets and liabilities that should be measured at fair value and those that should be measured at amortised cost, and it should remeasure those assets as appropriate. Any adjustment of the previous carrying amount should be recognised as an adjustment of the balance of retained earnings or, if appropriate, another category of equity* at the beginning of the financial year in which this Standard is initially applied;~~

* — Preparers are reminded of the requirement to apply the revised transitional provision consistently for all similar transactions and

- (e) at the beginning of the financial year in which this Standard is initially applied, any balance sheet positions in fair value hedges of existing assets and liabilities should be accounted for by adjusting their carrying amounts to reflect the fair value of the hedging instrument;
- (f) if an entity's hedge accounting policies prior to initial application of this Standard had included deferral, as assets and liabilities, of gains or losses on cash flow hedges, at the beginning of the financial year in which this Standard is initially applied, those deferred gains and losses should be reclassified as a separate component of equity to the extent that the transactions meet the criteria in paragraph 88 and, thereafter, accounted for as set out in paragraphs 97-100;
- (g) transactions entered into before the beginning of the financial year in which this Standard is initially applied should not be retrospectively designated as hedges;—
- (h) ~~[Deleted]if a securitisation, transfer, or other derecognition transaction was entered into prior to the beginning of the financial year in which this Standard is initially applied, the accounting for that transaction shall not be retrospectively changed to conform to the requirements of this Standard; and—~~
- (i) ~~[Deleted]sales or transfers of held-to-maturity investments before the beginning of the financial year in which this Standard is initially applied do not trigger the “tainting” rules in paragraph 9. If an entity has sold or transferred held-to-maturity investments previously so designated under SSAP 24 in the two preceding financial years, it is not prevented to continue to classify such financial assets as held-to-maturity investments at the beginning of the financial year in which this Standard is initially applied.~~

105- ~~[Deleted]~~

107A ~~When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset as available for sale. For any such financial asset the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall reclassify that cumulative gain or loss from equity to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)). The entity shall also:~~

- ~~(a) restate the financial asset using the new designation in the comparative financial statements; and~~

to disclose the accounting policy used in the notes to the financial statements.

- (b) ~~disclose the fair value of the financial assets at the date of designation and their classification and carrying amount in the previous financial statements.~~
- ~~105A An entity shall apply paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 for annual periods beginning on or after 1 January 2006. Earlier application is encouraged.~~
- ~~105B An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 in its annual period beginning before 1 January 2006.~~
- (a) ~~is permitted, when those new and amended paragraphs are first applied, to designate as at fair value through profit or loss any previously recognised financial asset or financial liability that then qualifies for such designation. When the annual period begins before 1 September 2005, such designations need not be completed until 1 September 2005 and may also include financial assets and financial liabilities recognised between the beginning of that annual period and 1 September 2005. Notwithstanding paragraph 91, any financial assets and financial liabilities designated as at fair value through profit or loss in accordance with this subparagraph that were previously designated as the hedged item in fair value hedge accounting relationships shall be de-designated from those relationships at the same time they are designated as at fair value through profit or loss.~~
- (b) ~~shall disclose the fair value of any financial assets or financial liabilities designated in accordance with subparagraph (a) at the date of designation and their classification and carrying amount in the previous financial statements.~~
- (c) ~~shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition.~~
- (d) ~~shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (c) at the date of de-designation and their new classifications.~~
- ~~105C An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 in its annual period beginning on or after 1 January 2006.~~
- (a) ~~shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss only if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition.~~
- (b) ~~shall not designate as at fair value through profit or loss any previously recognised financial assets or financial liabilities.~~

- ~~(c) shall disclose the fair value of any financial assets or financial liabilities designated in accordance with subparagraph (a) at the date of de-designation and their new classifications.~~

~~105D An entity shall restate its comparative financial statements using the new designations in paragraph 105B or 105C provided that, in the case of a financial asset, financial liability, or group of financial assets, financial liabilities or both, designated as at fair value through profit or loss, those items or groups would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the beginning of the comparative period or, if acquired after the beginning of the comparative period, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition.~~

~~106 [not used]~~

~~107 [not used]~~

~~107A Notwithstanding paragraph 104, an entity may apply the requirements in the last sentence of paragraph AG76, and paragraph AG76A, in either of the following ways:—~~

~~(a) prospectively to transactions entered into after 25 October 2002; or~~

~~(b) prospectively to transactions entered into after 1 January 2004~~

~~108 [not used]~~

108A An entity shall apply the last sentence of paragraph 80, and paragraphs AG99A and AG99B, for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity has designated as the hedged item an external forecast transaction that

- (a) is denominated in the functional currency of the entity entering into the transaction,
- (b) gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency), and
- (c) would have qualified for hedge accounting had it not been denominated in the functional currency of the entity entering into it,

it may apply hedge accounting in the consolidated financial statements in the period(s) before the date of application of the last sentence of paragraph 80, and paragraphs AG99A and AG99B.

- 108B An entity need not apply paragraph AG99B to comparative information relating to periods before the date of application of the last sentence of paragraph 80 and paragraph AG99A.
- 108C Paragraphs ~~9~~, 73 and AG8 were amended and paragraph ~~50A~~ added by *Improvements to HKFRSs*, issued in October 2008. Paragraph 80 was amended by *Improvements to HKFRSs*, issued in May 2009. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. ~~An entity shall apply the amendments in paragraphs 9 and 50A as of the date and in the manner it applied the 2005 amendments described in paragraph 105A.~~ Earlier application of all the amendments is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 108D *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to HKAS 39), issued in July 2013, amended paragraphs 91 and 101 and added paragraph AG113A. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 2014. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.
- 108E- ~~[Deleted]~~~~[Not used]~~
- 108F
- ~~108F *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraph 9 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.~~

Withdrawal of other pronouncements

- 109 This Standard supersedes SSAP 24 *Accounting for Investments in Securities*.

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 20 April 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 39.

The International Accounting Standard comparable with HKAS 39 is IAS 39, *Financial Instruments: Recognition and Measurement*.

There are no major textual differences between HKAS 39 and IAS 39.

Appendix A

Application guidance

This appendix is an integral part of the Standard.

Scope (paragraphs 2-7)

AG1- ~~[Deleted]~~

~~AG93 Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as ‘weather derivatives’.). If those contracts are not within the scope of HKFRS 4, they are within the scope of this Standard.~~

~~AG2 This Standard does not change the requirements relating to employee benefit plans that comply with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans* and royalty agreements based on the volume of sales or service revenues that are accounted for under HKAS 18 *HKFRS 15 Revenue from Contracts with Customers*.~~

~~AG3 Sometimes, an entity makes what it views as a ‘strategic investment’ in equity instruments issued by another entity, with the intention of establishing or maintaining a long term operating relationship with the entity in which the investment is made. The investor or joint venturer entity uses HKAS 28 to determine whether the equity method of accounting is appropriate for such an investment. If the equity method is not appropriate, the entity applies this Standard to that strategic investment.~~

~~AG3A This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of HKFRS 4.~~

~~AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):~~

- ~~(a) Although a financial guarantee contract meets the definition of an insurance contract in HKFRS 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand alone arm’s length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29-37 and AG47-AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:~~

- (i) ~~the amount determined in accordance with HKAS 37; and~~
 - (ii) ~~the amount initially recognised less, when appropriate, the cumulative amortisation amount of income recognised in accordance with HKAS 18 the principles of HKFRS 15 (see paragraph 47(c)).~~
-
- (b) ~~Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in HKFRS 4. Such guarantees are derivatives and the issuer applies this Standard to them.~~
 - (c) ~~If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies HKAS 18 HKFRS 15 in determining when it recognises the revenue from the guarantee and from the sale of goods.~~

~~AG4A Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.~~

Definitions (paragraphs 8-9)

Designation as at fair value through profit or loss

~~AG4B Paragraph 9 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.~~

~~AG4C The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 9 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 9, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.~~

~~*Paragraph 9(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise*~~

~~AG4D~~ Under HKAS 39, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised in other comprehensive income) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

~~AG4E~~ The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(i).—

- ~~(a) — An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in profit or loss in the same period as related changes in the value of the liabilities.~~
- ~~(b) — An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by HKFRS 4, paragraph 24), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.—~~
- ~~(c) — An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 are not met.~~
- ~~(d) — An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:

 - ~~(i) — the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes recognised in other comprehensive income and the debentures at amortised cost.~~~~

- (ii) ~~the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.~~

~~AG4F In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.~~

~~AG4G It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100* and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.~~

Paragraph 9(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

~~AG4H An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.~~

~~AG4I The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(ii).~~

* In this Standard, monetary amounts are denominated in 'currency units' (CU).

- (a) ~~The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. HKAS 28 allows such investments to be measured at fair value through profit or loss in accordance with this Standard. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of HKAS 28.~~
- (b) ~~The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.~~
- (c) ~~The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (ie interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (eg a year) or are subject to the insurer's discretion.~~

~~AG4J As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.~~

~~AG4K Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department as approved by the entity's key management personnel clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).~~

~~Effective interest rate~~

~~AG5 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.~~

~~AG6—When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.~~

~~AG7—For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.~~

~~AG8—If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense. If a financial asset is reclassified in accordance with paragraph 50B, 50D or 50E, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.~~

~~AG8A—In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue when the instrument is initially recognised.~~

~~AG8B—Fees that are an integral part of the effective interest rate of a financial instrument include:~~

- ~~(a) —origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting~~

financial instrument.

- ~~(b) — commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of this Standard and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.~~
- ~~(c) — origination fees received on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.~~

~~AG8C Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with HKFRS 15 include:~~

- ~~(a) — fees charged for servicing a loan;~~
- ~~(b) — commitment fees to originate a loan when the loan commitment is outside the scope of this Standard and it is unlikely that a specific lending arrangement will be entered into; and~~
- ~~(c) — loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).~~

~~Derivatives~~

~~AG9 — Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000 if six month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.~~

~~AG10 — The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (eg a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (eg a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5-7).~~

~~AG11 — One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that~~

~~definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.~~

~~AG12 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38 and AG53-AG56).~~

~~AG12A The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.~~

~~Transaction costs~~

~~AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.~~

~~Financial assets and financial liabilities held for trading~~

~~AG14 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.~~

~~AG15 Financial liabilities held for trading include:~~

- ~~(a) derivative liabilities that are not accounted for as hedging instruments;~~
- ~~(b) obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed and does not yet own);~~
- ~~(c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and~~
- ~~(d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking.~~

~~The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.~~

~~Held-to-maturity investments~~

~~AG16 An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:—~~

- ~~(a) the entity intends to hold the financial asset for an undefined period;—~~
- ~~(b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or—~~
- ~~(c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.~~

~~AG17 A debt instrument with a variable interest rate can satisfy the criteria for a held to maturity investment. Equity instruments cannot be held to maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held to maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.—~~

~~AG18 The criteria for classification as a held to maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held to maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.—~~

~~AG19 A financial asset that is puttable (ie the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held to maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.—~~

~~AG20 For most financial assets, fair value is a more appropriate measure than amortised cost. The held to maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 9 precludes the use of the exception for a reasonable period of time.—~~

~~AG21 A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.—~~

~~AG22 Sales before maturity could satisfy the condition in paragraph 9 and therefore not raise a question about the entity's intention to hold other investments to maturity if they are attributable to any of the following:~~

- ~~(a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 58 and 59), the deterioration in creditworthiness is often regarded as significant.~~
- ~~(b) a change in tax law that eliminates or significantly reduces the tax exempt status of interest on the held to maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).~~
- ~~(c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held to maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).~~
- ~~(d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held to maturity investment.~~
- ~~(e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held to maturity investments.~~
- ~~(f) a significant increase in the risk weights of held to maturity investments used for regulatory risk based capital purposes.~~

~~AG23 An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:~~

- ~~(a) it does not have the financial resources available to continue to finance the investment until maturity; or~~
- ~~(b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity see paragraph AG18.)~~

~~AG24 Circumstances other than those described in paragraphs AG16 AG23 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.~~

~~AG25 An entity assesses its intention and ability to hold its held to maturity investments to~~

maturity not only when those financial assets are initially recognised, but also at the end of each subsequent reporting period.

Loans and receivables

AG26—Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG71) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 9 and AG16-AG25). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

Embedded derivatives (paragraphs 10-13)

AG27—If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG28—An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

AG29—Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see HKAS 32) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG30—The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a)—A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b)—A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the

~~conditions for that classification under HKAS 32, in which case it is excluded from the scope of this Standard).~~

- ~~(c) — An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.~~
- ~~(d) — Equity indexed interest or principal payments embedded in a host debt instrument or insurance contract by which the amount of interest or principal is indexed to the value of equity instruments are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.~~
- ~~(e) — Commodity indexed interest or principal payments embedded in a host debt instrument or insurance contract by which the amount of interest or principal is indexed to the price of a commodity (such as gold) are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.~~
- ~~(f) — An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under HKAS 32).~~
- ~~(g)* — A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:~~
 - ~~(i) — the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or~~
 - ~~(ii) — the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.~~

~~The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with HKAS 32.~~

- ~~(h) — Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to~~

* — Amendment effective for annual periods beginning on or after 1 January 2010.

~~the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.~~

~~AG31—An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a ‘puttable instrument’). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG27 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG30(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.~~

~~AG32—In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open ended mutual fund or some unit linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.~~

~~AG33—The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.~~

~~(a)——An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder’s initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.~~

~~(b)——An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.~~

~~(c)——An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because HKAS 21 requires foreign currency gains and losses on monetary items to be recognised in profit or loss.~~

~~(d)——An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale~~

~~of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature and requires payments denominated in one of the following currencies:—~~

- ~~(i) — the functional currency of any substantial party to that contract;—~~
- ~~(ii) — the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or—~~
- ~~(iii) — a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).—~~
- ~~(e) — An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.—~~
- ~~(f) — An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.—~~
- ~~(g) — A unit linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.—~~
- ~~(h) — A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).—~~

Instruments containing embedded derivatives

~~AG33A When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.~~

~~AG33B Such designation may be used whether paragraph 11 requires the embedded derivatives~~

~~to be separated from the host contract or prohibits such separation. However, paragraph 11A would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11A(a) and (b) because doing so would not reduce complexity or increase reliability.~~

~~Recognition and derecognition (paragraphs 14-42)~~

~~Initial recognition (paragraph 14)~~

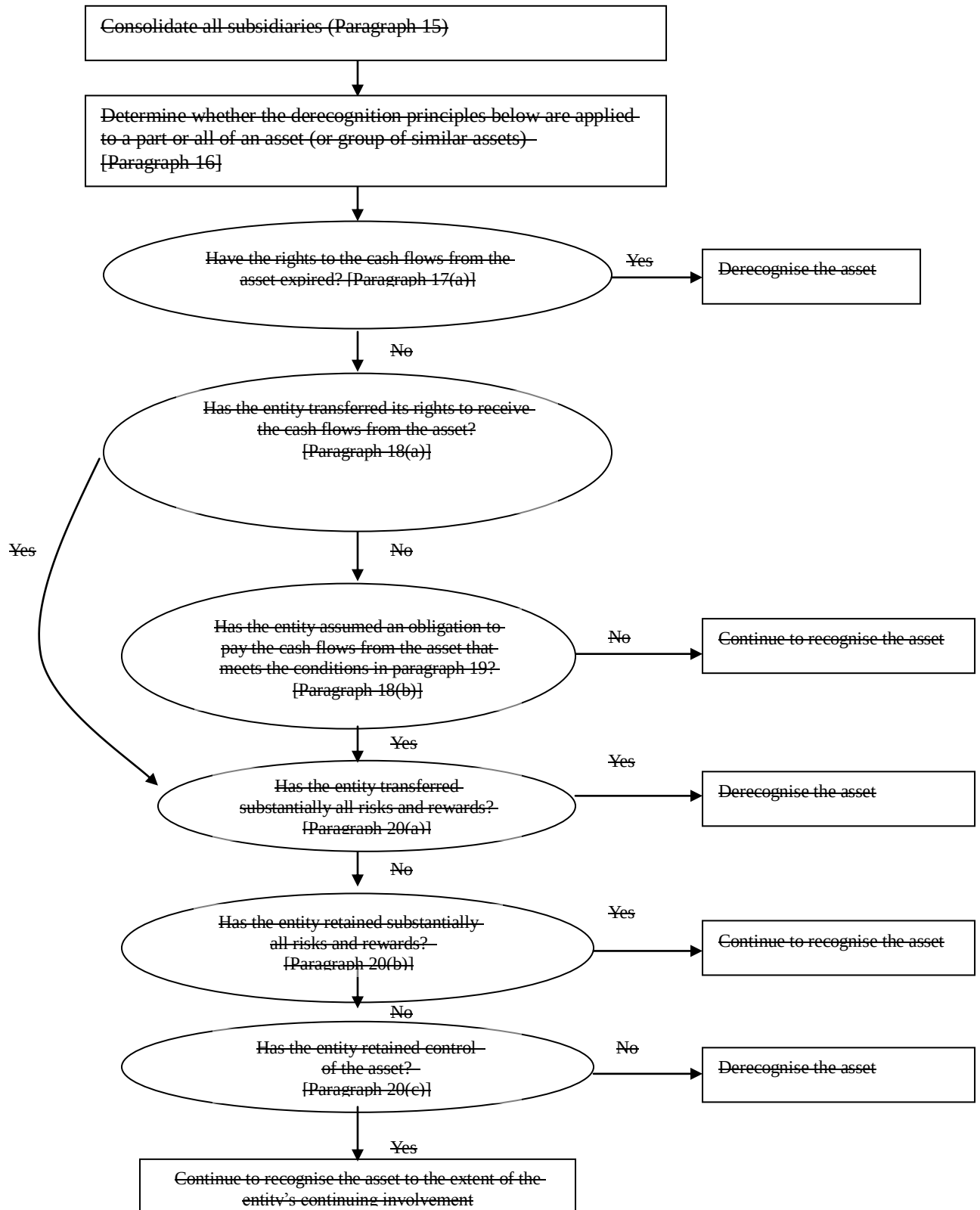
~~AG34 As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG49). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG50).~~

~~AG35 The following are examples of applying the principle in paragraph 14:~~

- ~~(a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.~~
- ~~(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 5-7, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94).~~
- ~~(c) a forward contract that is within the scope of this Standard (see paragraphs 2-7) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.~~
- ~~(d) option contracts that are within the scope of this Standard (see paragraphs 2-7) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.~~
- ~~(e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.~~

~~Derecognition of a financial asset (paragraphs 15–37)~~

AG36 ~~The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.~~



~~Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 18(b))—~~

~~AG37 The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.—~~

~~AG38 In applying paragraph 19, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a subsidiary that has acquired the financial asset and passes on cash flows to unrelated third party investors.—~~

~~Evaluation of the transfer of risks and rewards of ownership (paragraph 20)~~

~~AG39 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:—~~

- ~~(a) an unconditional sale of a financial asset;—~~
- ~~(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and—~~
- ~~(c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).—~~

~~AG40 Examples of when an entity has retained substantially all the risks and rewards of ownership are:—~~

- ~~(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;—~~
- ~~(b) a securities lending agreement;—~~
- ~~(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;—~~
- ~~(d) a sale of a financial asset together with a deep in the money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and—~~
- ~~(e) a sale of short term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.—~~

~~AG41 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.—~~

~~Evaluation of the transfer of control~~

~~AG42—An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.—~~

~~AG43—The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:—~~

~~(a)—a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and—~~

~~(b)—an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:—~~

~~(i)—the transferee's ability to dispose of the transferred asset must be independent of the actions of others (ie it must be a unilateral ability); and—~~

~~(ii)—the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (eg conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).—~~

~~AG44—That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.—~~

~~Transfers that qualify for derecognition~~

~~AG45—An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire~~

~~interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.—~~

~~AG46—When measuring the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in HKFRS 13 in addition to paragraph 28.—~~

~~Transfers that do not qualify for derecognition—~~

~~AG47—The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.—~~

~~Continuing involvement in transferred assets—~~

~~AG48—The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30:~~

~~All assets—~~

- ~~(a)—If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis when (or as) the obligation is satisfied (see HKAS 18 in accordance with the principles of HKFRS 15) and the carrying value of the asset is reduced by any impairment losses.—~~

~~Assets measured at amortised cost~~

- ~~(b)—If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (ie the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the~~

exercise price is recognised in profit or loss.—

Assets measured at fair value—

- (c) — If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 — CU5) and the carrying amount of the transferred asset is CU80 (ie its fair value).—
- (d) — If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).—
- (e) — If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) — CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.—

All transfers—

~~AG49—To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.~~

~~AG50—To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.~~

Examples—

~~AG51—The following examples illustrate the application of the derecognition principles of this Standard.~~

~~(a)—*Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.~~

~~(b)—*Repurchase agreements and securities lending—assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.~~

~~(c)—*Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.~~

~~(d)—*Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.~~

- (e) ~~*Wash sale transaction.*~~ The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.
- (f) ~~*Put options and call options that are deeply in the money.*~~ If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) ~~*Put options and call options that are deeply out of the money.*~~ A financial asset that is transferred subject only to a deep out of the money put option held by the transferee or a deep out of the money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) ~~*Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.*~~ If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) ~~*A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.*~~ If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph AG44). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.
- (j) ~~*Assets subject to a fair value put or call option or a forward repurchase agreement.*~~ A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.

- ~~(k) — *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG44 and (g), (h) and (i) above).~~
- ~~(l) — *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.~~
- ~~(m) — *Clean up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.~~
- ~~(n) — *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.~~
- ~~(o) — *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.~~
- ~~(p) — *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.~~

- ~~(e) — *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.~~

~~AG52 — This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.~~

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining CU9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is CU10,100 and the fair value of the excess spread of 0.5 per cent is CU40.—

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.—

To apply this Standard, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of CU1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.—

The entity calculates that CU9,090 (90 per cent CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).—

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

	<i>—Fair value</i>	<i>Percentage</i>	<i>Allocated carrying amount</i>
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, ie CU90 (CU9,090 — CU9,000). The carrying amount of the portion retained by the entity is CU1,000.—

~~In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, ie CU1,000 plus the fair value of the subordination of CU65).~~

~~The entity uses all of the above information to account for the transaction as follows:~~

	<i>Debit</i>	<i>Credit</i>
~~Original asset~~	~~-~~	~~9,000~~
~~Asset recognised for subordination or the residual interest~~	~~1,000~~	~~-~~
~~Asset for the consideration received in the form of excess spread~~	~~40~~	~~-~~
~~Profit or loss (gain on transfer)~~	~~-~~	~~90~~
~~Liability~~	~~-~~	~~1,065~~
~~Cash received~~	~~9,115~~	~~-~~
~~Total~~	~~10,155~~	~~10,155~~

~~Immediately following the transaction, the carrying amount of the asset is CU2,040 comprising CU1,000, representing the allocated cost of the portion retained, and CU1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of CU40).~~

~~In subsequent periods, the entity recognises the consideration received for the credit enhancement (CU65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognizes any credit impairment on the recognised assets. As an example of the latter, assume that in the following year there is a credit impairment loss on the underlying loans of CU300. The entity reduces its recognised asset by CU600 (CU300 relating to its retained interest and CU300 relating to the additional continuing involvement that arises from the subordination of its retained interest for credit losses), and reduces its recognised liability by CU300. The net result is a charge to profit or loss for credit impairment of CU300.~~

~~Regular way purchase or sale of a financial asset (paragraph 38)~~

~~AG53 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs AG55 and AG56. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 9. For this purpose assets that are held for trading form a separate category from assets designated at fair value through profit or loss.~~

~~AG54 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.~~

~~AG55 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.~~

~~AG56 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in other comprehensive income for assets classified as available for sale.~~

~~Derecognition of a financial liability (paragraphs 39-42)~~

~~AG57 A financial liability (or part of it) is extinguished when the debtor either:~~

- ~~(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or~~
- ~~(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)~~

~~AG58 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.~~

~~AG59 Payment to a third party, including a trust (sometimes called 'in substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.~~

~~AG60 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG57(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.~~

~~AG61 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 15-37 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.~~

~~AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.~~

~~AG63 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:~~

- ~~(a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and~~
- ~~(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.~~

~~Measurement (paragraphs 43–70)~~

~~Initial measurement of financial assets and financial liabilities (paragraph 43)~~

~~AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also HKFRS 13 and paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.~~

~~AG65 If an entity originates a loan that bears an off market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an up front fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest method.~~

~~Subsequent measurement of financial assets (paragraphs 45 and 46)~~

~~AG66 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability in accordance with paragraph 47.~~

~~AG67 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available for sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognised at CU102.~~

~~The end of the reporting period occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognised in other comprehensive income. If the available for sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available for sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.~~

~~AG68 Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity.~~

~~AG69 AG75 [Deleted]~~

~~AG76 The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received; see also HKFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 43A, the entity shall account for that instrument at that date as follows:~~

- ~~(a) at the measurement required by paragraph 43 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.~~
- ~~(b) in all other cases, at the measurement required by paragraph 43, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.~~

~~AG76A The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard.~~

~~AG77 AG 79 [Deleted]~~

~~No active market: equity instruments~~

~~AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market for an identical instrument (ie a Level 1 input) and derivatives that are linked to and must be settled by delivery of such an equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.~~

~~AG81 There are many situations in which the variability in the range of reasonable fair value measurements of investments in equity instruments that do not have a quoted price in an active market for an identical instrument (ie a Level 1 input) and derivatives that are linked to and must be settled by delivery of such an equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to measure the fair~~

value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value measurements is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.—

AG82 ~~[Deleted]~~

~~Gains and losses (paragraphs 55-57)~~

AG83 ~~An entity applies HKAS 21 to financial assets and financial liabilities that are monetary items in accordance with HKAS 21 and denominated in a foreign currency. Under HKAS 21, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95-101) or a hedge of a net investment (see paragraph 102). For the purpose of recognising foreign exchange gains and losses under HKAS 21, a monetary available for sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in accordance with paragraph 55(b). For available for sale financial assets that are not monetary items under HKAS 21 (for example, equity instruments), the gain or loss that is recognised in other comprehensive income under paragraph 55(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.—~~

~~Impairment and uncollectibility of financial assets— (paragraphs 58-70)~~

~~Financial assets carried at amortised cost (paragraphs 63-65)~~

AG84 ~~Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held to maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held to maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.—~~

AG85 ~~The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.—~~

AG86 ~~The process for estimating the amount of an impairment loss may result either in a single~~

~~amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range^{*} taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period.~~

- ~~AG87 For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.~~
- ~~AG88 Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.~~
- ~~AG89 Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.~~
- ~~AG90 As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.~~

^{*} — HKAS 37, paragraph 39 contains guidance on how to determine the best estimate in a range of possible outcomes.

~~AG91 When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.~~

~~AG92 Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (eg for smaller balance loans) as long as they are consistent with the requirements in paragraphs 63-65 and AG87-AG91. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.~~

~~Interest income after impairment recognition~~

~~AG93 Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.~~

Hedging (paragraphs 71-102)

Hedging instruments (paragraphs 72-77)

Qualifying instruments (paragraphs 72 and 73)

AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

AG95 ~~A financial asset measured at amortised cost~~ ~~A held-to-maturity investment carried at amortised cost~~ may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 ~~[Deleted] An investment in an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) is not carried at fair value because its fair value cannot otherwise be reliably measured or a derivative that is linked to and must be settled by delivery of such an equity instrument (see paragraphs 46(c) and 47) cannot be designated as a hedging instrument.~~

AG97 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged items (paragraphs 78-84)

Qualifying items (paragraphs 78-80)

- AG98 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.
- AG99 An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.
- AG99A Paragraph 80 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.
- AG99B If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive income in accordance with paragraph 95(a) shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.
- AG99BA* An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the

* — Amendment effective for annual periods beginning on or after 1 July 2009.

price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).

Designation of financial items as hedged items (paragraphs 81 and 81A)

AG99C If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (ie principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

AG99D In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie CU90) and the amount repayable on maturity (ie CU100).

AG99E* Paragraph 81 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:

- (a) all of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or
- (b) some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (ie a 'portion' of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

AG99F* To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:

* — Amendments effective for annual periods beginning on or after 1 July 2009.

- (a) for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.
- (b) inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.
- (c) a contractually specified inflation portion of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

Designation of non-financial items as hedged items (paragraph 82)

AG100 Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 88 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (eg a transaction in Brazilian coffee) and the hedging instrument (eg a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (ie between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in profit or loss during the term of the hedging relationship.

Designation of groups of items as hedged items (paragraphs 83 and 84)

AG101 A hedge of an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm purchase commitment of CU100.

Hedge accounting (paragraphs 85-102)

AG102 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG103 An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

AG104 A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 87 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing hedge effectiveness

AG105 A hedge is regarded as highly effective only if both of the following conditions are met:

- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.
- (b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instrument is CU100, offset can be measured by $120 / 100$, which is 120 per cent, or by $100 / 120$, which is 83 per cent. In this example, assuming the hedge meets the condition in (a) the entity would conclude that the hedge has been highly effective.

AG106 Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

AG107 This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However,

when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

AG108 If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

- (a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
- (b) the fair value of the forward contract at inception is zero; and
- (c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognised in profit or loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

AG109 Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG110 To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG110A* Paragraph 74(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

AG110B* If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG99BA, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.

* — Amendments effective for annual periods beginning on or after 1 July 2009.

- AG111 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.
- AG112 In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.
- AG113 If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.
- AG113A For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraphs 91(a)(ii) and 101(a)(ii) shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Fair value hedge accounting for a portfolio hedge of interest rate risk

- AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs AG115-AG132 below.
- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios ~~(eg the entity may group its available for sale assets into a separate portfolio)~~, in which case it applies the guidance below to each portfolio separately.
 - (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.
 - (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG126(b).
 - (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (eg LIBOR).
 - (e) The entity designates one or more hedging instruments for each repricing time

period.

- (f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in profit or loss and in one of two line items in the statement of financial position as described in paragraph 89A. The change in fair value need not be allocated to individual assets or liabilities.
- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in profit or loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the statement of financial position.
- (i) Any ineffectiveness* will be recognised in profit or loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

AG115 This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG116 The portfolio identified in paragraph AG114(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG117 In applying paragraph AG114(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures and objectives.

AG118 As an example of the designation set out in paragraph AG114(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates

* The same materiality considerations apply in this context as apply throughout HKFRSs.

as the hedged item assets in the amount of CU20 (a portion of the assets).[†] The designation is expressed as an ‘amount of a currency’ (eg an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—ie all of the CU100 of assets in the above example—must be:

- (a) items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because ~~HKFRS 9—the Standard~~[‡] specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG126(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 per cent^{*} of the liabilities with no demand feature.

AG119 The entity also complies with the other designation and documentation requirements set out in paragraph 88(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity’s policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

- (a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.
- (b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.
- (c) the number and duration of repricing time periods.
- (d) how often the entity will test effectiveness and which of the two methods in paragraph AG126 it will use.
- (e) the methodology used by the entity to determine the amount of assets or

[†] The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, ie in this example any amount of assets between CU0 and CU100.

[‡] ~~see paragraph 49~~

^{*} $CU30 \div (CU100 - CU40) = 50 \text{ per cent}$

liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG126(b).

- (f) when the entity tests effectiveness using the method described in paragraph AG126(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship shall be in accordance with the entity's risk management procedures and objectives. Changes in policies shall not be made arbitrarily. They shall be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

AG120 The hedging instrument referred to in paragraph AG114(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG114(d) (eg a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[†] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG114(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard^{*} does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG121 When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG114(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 81 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 81A permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than *contractual*, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (eg to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG126. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (eg changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

[†] see paragraphs 77 and AG94

^{*} see paragraph 75

AG122 The Standard does not specify the techniques used to determine the amount referred to in paragraph AG114(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

AG123 Paragraph 89A requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG114(g). Specific allocation to individual assets (or liabilities) is not required.

AG124 Paragraph AG114(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

- (a) actual repricing dates being different from those expected, or expected repricing dates being revised;
- (b) items in the hedged portfolio becoming impaired or being derecognised;
- (c) the payment dates of the hedging instrument and the hedged item being different; and
- (d) other causes (eg when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness* shall be identified and recognised in profit or loss.

AG125 Generally, the effectiveness of the hedge will be improved:

- (a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.
- (b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.
- (c) when the repricing time periods used are narrower (eg 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduce the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.
- (d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (eg because of changes in prepayment expectations).

AG126 An entity tests effectiveness periodically. If estimates of repricing dates change between

* The same materiality considerations apply in this context as apply throughout HKFRSs.

one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

- (a) as the difference between the change in the fair value of the hedging instrument (see paragraph AG114(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or
- (b) using the following approximation. The entity:
 - (i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.
 - (ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.
 - (iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG114(g).
 - (iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG114(h)).

AG127 When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG121), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG126(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG126(b) are then repeated at the next date it tests effectiveness.

AG128 Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG114(g) that relates to the derecognised item shall be removed from the statement of financial position, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG114(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

- AG129 In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in profit or loss at that time (see paragraph 89A). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item in the statement of financial position was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, CU7 is derecognised from the statement of financial position and recognised in profit or loss. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG114(g).
- AG130 As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU100 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG114(g) that relates to the first time period is removed from the statement of financial position, plus 10 per cent of the amount that relates to the second time period.
- AG131 If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph AG114(g) that relates to the reduction shall be amortised in accordance with paragraph 92.
- AG132 An entity may wish to apply the approach set out in paragraphs AG114-AG131 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with HKAS 39. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 101(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG114-AG131 prospectively to subsequent accounting periods.

Transition (paragraphs 103-108CB)

- AG133 An entity may have designated a forecast intragroup transaction as a hedged item at the start of an annual period beginning on or after 1 January 2005 (or, for the purpose of restating comparative information, the start of an earlier comparative period) in a hedge that would qualify for hedge accounting in accordance with this Standard (as amended by the last sentence of paragraph 80). Such an entity may use that designation to apply hedge accounting in consolidated financial statements from the start of the annual period beginning on or after 1 January 2005 (or the start of the earlier comparative period). Such an entity shall also apply paragraphs AG99A and AG99B from the start of the annual period beginning on or after 1 January 2005. However, in accordance with paragraph 108B, it need not apply paragraph AG99B to comparative information for earlier periods.

Appendix B

Amendments to Other Pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Basis for Conclusions
Hong Kong Accounting Standard 39

Financial Instruments:

Recognition and Measurement



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

This Basis for Conclusions accompanies, but is not part of, IAS 39.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements (as revised in 2007).

Reference to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

IFRS 9 Financial Instruments replaced IAS 39. However the Board did not reconsider most of the requirements of IAS 39 relating to scope, classification and measurement of financial liabilities or derecognition of financial assets and financial liabilities. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC15-BC24Y, BC30-BC79A and BC85-BC104.

HKAS 39 is based on IAS 39 *Financial Instruments: Recognition and Measurement*. In approving HKAS 39, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 39. Accordingly, there are no significant differences between HKAS 39 and IAS 39. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 39 referred to below generally correspond with those in HKAS 39.

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions on revising IAS 39 *Financial Instruments: Recognition and Measurement* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2- ~~[Deleted]~~

~~BC130 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, with a comment deadline of 14 October 2002. In August 2003 the Board published a further Exposure Draft of Proposed Amendments to IAS 39 on *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003.~~

~~BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and IAS 39, this Basis for Conclusions does not discuss requirements in IAS 39 that the Board has not reconsidered.~~

~~Background~~

~~BC4 The original version of IAS 39 became effective for financial statements covering financial years beginning on or after 1 January 2001. It reflected a mixed measurement model in which some financial assets and financial liabilities are measured at fair value and others at cost or amortised cost, depending in part on an entity's intention in holding an instrument.~~

~~BC5 The Board recognises that accounting for financial instruments is a difficult and~~

~~controversial subject. The Board's predecessor body, the International Accounting Standards Committee (IASC) began its work on the issue some 15 years ago, in 1988. During the next eight years it published two Exposure Drafts, culminating in the issue of IAS 32 on disclosure and presentation in 1995. IASC decided that its initial proposals on recognition and measurement should not be progressed to a Standard, in view of:~~

- ~~• the critical response they had attracted;~~
- ~~• evolving practices in financial instruments; and~~
- ~~• the developing thinking by national standard-setters.~~

~~BC6 Accordingly, in 1997 IASC published, jointly with the Canadian Accounting Standards Board, a discussion paper that proposed a different approach, namely that all financial assets and financial liabilities should be measured at fair value. The responses to that paper indicated both widespread unease with some of its proposals and that more work needed to be done before a standard requiring a full fair value approach could be contemplated.~~

~~BC7 In the meantime, IASC concluded that a standard on the recognition and measurement of financial instruments was needed urgently. It noted that although financial instruments were widely held and used throughout the world, few countries apart from the United States had any recognition and measurement standards for them. In addition, IASC had agreed with the International Organization of Securities Commissions (IOSCO) that it would develop a set of 'core' International Accounting Standards that could be endorsed by IOSCO for the purpose of cross-border capital raising and listing in all global markets. Those core standards included one on the recognition and measurement of financial instruments. Accordingly, IASC developed the version of IAS 39 that was issued in 2000.~~

~~BC8 In December 2000 a Financial Instruments Joint Working Group of Standard Setters (JWG), comprising representatives or members of accounting standard-setters and professional organisations from a range of countries, published a Draft Standard and Basis for Conclusions entitled *Financial Instruments and Similar Items*. That Draft Standard proposed far-reaching changes to accounting for financial instruments and similar items, including the measurement of virtually all financial instruments at fair value. In the light of feedback on the JWG's proposals, it is evident that much more work is needed before a comprehensive fair value accounting model could be introduced.~~

~~BC9 In July 2001 the Board announced that it would undertake a project to improve the existing requirements on the accounting for financial instruments in IAS 32 and IAS 39. The improvements deal with practice issues identified by audit firms, national standard-setters, regulators and others, and issues identified in the IAS 39 implementation guidance process or by IASB staff.~~

~~BC10 In June 2002 the Board published an Exposure Draft of proposed amendments to IAS 32 and IAS 39 for a 116 day comment period. More than 170 comment letters were received.~~

~~BC11 Subsequently, the Board took steps to enable constituents to inform it better about the main issues arising out of the comment process, and to enable the Board to explain its views of the issues and its tentative conclusions. These consultations included:~~

- ~~(a) discussions with the Standards Advisory Council on the main issues raised in the comment process.~~
- ~~(b) nine round table discussions with constituents during March 2003 conducted in~~

~~Brussels and London. Over 100 organisations and individuals took part in those discussions.~~

- ~~(c) — discussions with the Board's liaison standard setters of the issues raised in the round table discussions.~~
- ~~(d) — meetings between members of the Board and its staff and various groups of constituents to explore further issues raised in comment letters and at the round table discussions.~~

~~BC11A Some of the comment letters on the June 2002 Exposure Draft and participants in the round tables raised a significant issue for which the June 2003 Exposure Draft had not proposed any changes. This was hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as 'macro hedging') and the related question of the treatment in hedge accounting of deposits with a demand feature (sometimes referred to as 'demand deposits' or 'demandable liabilities'). In particular, some were concerned that it was very difficult to achieve fair value hedge accounting for a macro hedge in accordance with previous versions of IAS 39.~~

~~BC11B In the light of these concerns, the Board decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. This resulted in a further Exposure Draft of Proposed Amendments to IAS 39 that was published in August 2003 and on which more than 120 comment letters were received. The amendments proposed in the Exposure Draft were finalised in March 2004.~~

~~BC11C After those amendments were issued in March 2004 the Board received further comments from constituents calling for further amendments to the Standard. In particular, as a result of continuing discussions with constituents, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. These constituents were concerned that:~~

- ~~(a) — entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.~~
- ~~(b) — the use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.~~
- ~~(c) — if an entity applied the fair value option to financial liabilities, it might result in an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.~~

~~In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option. In March 2005 the Board held a series of round table meetings to discuss proposals with invited constituents. As a result of this process, the Board issued an amendment to IAS 39 in June 2005 relating to the fair value option.~~

~~BC11D In September 2007, following a request from the International Financial Reporting Interpretations Committee (IFRIC), the Board published *Exposures Qualifying for Hedge Accounting*, an exposure draft of proposed amendments to IAS 39. The Board's objective~~

~~was to clarify its requirements on exposures qualifying for hedge accounting and to provide additional guidance by specifying eligible risks and portions of cash flows. The Board received 75 responses to the exposure draft. Many respondents raised concerns about the rule-based approach proposed in the exposure draft. Their responses indicated that there was little diversity in practice regarding the designation of hedged items. However, the responses demonstrated that diversity in practice existed, or was likely to occur, in the two situations set out in paragraph BC172C. After considering the responses, the Board decided to focus on those two situations. Rather than specifying eligible risks and portions as proposed in the exposure draft, the Board decided to address those situations by adding application guidance to illustrate how the principles underlying hedge accounting should be applied. The Board subsequently issued *Eligible Hedged Items* (Amendment to IAS 39) in July 2008. The rationale for the amendment is set out in paragraphs BC172B–BC172J.~~

~~BC11E In October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP (Statements of Financial Accounting Standards No. 115 *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115) and No. 65 *Accounting for Certain Mortgage Banking Activities* (SFAS 65) issued by the US Financial Accounting Standards Board). In response the Board issued *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008. The amendments to IAS 39 permit non-derivative financial assets held for trading and available-for-sale financial assets to be reclassified in particular situations. The rationale for the amendments is set out in paragraphs BC104A–BC104E.~~

~~BC11F Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. In response the Board issued *Embedded Derivatives* (Amendments to IFRIC 9 and IAS 39) in March 2009. The amendment to IAS 39 clarifies the consequences if the fair value of the embedded derivative that would have to be separated cannot be measured separately.~~

~~BC12 The Board did not reconsider the fundamental approach to accounting for financial instruments contained in IAS 39.* Some of the complexity in existing requirements is inevitable in a mixed measurement model based in part on management's intentions for holding financial instruments and given the complexity of finance concepts and fair value estimation issues. The amendments reduce some of the complexity by clarifying the Standard, eliminating internal inconsistencies and incorporating additional guidance into the Standard.~~

~~BC13 The amendments also eliminate or mitigate some differences between IAS 39 and US GAAP related to the measurement of financial instruments. Already, the measurement requirements in IAS 39 are, to a large extent, similar to equivalent requirements in US GAAP, in particular, those in FASB SFAS 114 *Accounting by Creditors for Impairment of a Loan*, SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* and SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*.~~

~~BC14 The Board will continue its consideration of issues related to the accounting for financial instruments. However, it expects that the basic principles in the improved IAS 39 will be in place for a considerable period.~~

~~Scope~~

~~Loan commitments (paragraphs 2(h) and 4)~~

~~BC15 Loan commitments are firm commitments to provide credit under pre-specified terms and~~

*—In 2011 the Board's project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.

conditions. In the IAS 39 implementation guidance process, the question was raised whether a bank's loan commitments are derivatives accounted for at fair value under IAS 39. This question arises because a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. In effect, it is a written option for the potential borrower to obtain a loan at a specified rate.—

~~BC16 To simplify the accounting for holders and issuers of loan commitments, the Board decided to exclude particular loan commitments from the scope of IAS 39. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).—~~

~~BC17 However, the Board decided that an entity should be permitted to measure a loan commitment at fair value with changes in fair value recognised in profit or loss on the basis of designation at inception of the loan commitment as a financial liability through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis.—~~

~~BC18 The Board further decided that a loan commitment should be excluded from the scope of IAS 39 only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is difficult to justify its exclusion from the requirement in IAS 39 to measure at fair value similar instruments that meet the definition of a derivative.—~~

~~BC19 Some comments received on the Exposure Draft disagreed with the Board's proposal that an entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IAS 39 to all of its loan commitments. The Board considered this concern and agreed that the words in the Exposure Draft did not reflect the Board's intention. Thus, the Board clarified that if an entity has a past practice of selling the assets resulting from its loan commitments shortly after origination, it applies IAS 39 only to its loan commitments in the same class.—~~

~~BC20 Finally, the Board decided that commitments to provide a loan at a below market interest rate should be initially measured at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue**. It noted that without such a requirement, liabilities that result from such commitments might not be recognised in the balance sheet, because in many cases no cash consideration is received.—~~

~~BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on loan commitments from the scope section of the Standard to the section on subsequent measurement (paragraph 47(d)). The purpose of this change was to rationalise the presentation of this material without making substantive changes.—~~

~~Financial guarantee contracts (paragraphs 2(e), 9, 47(c), AG4 and AG4A)—~~

*— IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 47 of IAS 39 for consistency with the requirements in IFRS 15.

~~BC21 In finalising IFRS 4 *Insurance Contracts* in early 2004, the Board reached the following conclusions:~~

- ~~(a) Financial guarantee contracts can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. However, although this difference in legal form may in some cases reflect differences in substance, the accounting for these instruments should not depend on their legal form.~~
- ~~(b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39. This was the case before the Board finalised IFRS 4.~~
- ~~(c) As required before the Board finalised IFRS 4, if a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if it is an insurance contract, as defined in IFRS 4.~~
- ~~(d) Unless (c) applies, the following treatment is appropriate for a financial guarantee contract that meets the definition of an insurance contract:~~
 - ~~(i) At inception, the issuer of a financial guarantee contract has a recognisable liability and should measure it at fair value. If a financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.~~
 - ~~(ii) Subsequently, the issuer should measure the contract at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.^{*}~~

~~BC22 Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board finalised IFRS 4 in early 2004 without specifying the accounting for these contracts and then published an Exposure Draft *Financial Guarantee Contracts and Credit Insurance* in July 2004 to expose for public comment the conclusion set out in paragraph BC21(d). The Board set a comment deadline of 8 October 2004 and received more than 60 comment letters. Before reviewing the comment letters, the Board held a public education session at which it received briefings from representatives of the International Credit Insurance & Surety Association and of the Association of Financial Guaranty Insurers.~~

~~BC23 Some respondents to the Exposure Draft of July 2004 argued that there were important economic differences between credit insurance contracts and other forms of contract that met the proposed definition of a financial guarantee contract. However, both in developing the Exposure Draft and in subsequently discussing the comments received, the Board was unable to identify differences that would justify differences in accounting treatment.~~

^{*} ~~IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 47 of IAS 39 for consistency with the requirements in IFRS 15.~~

~~BC23A Some respondents to the Exposure Draft of July 2004 noted that some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not address until phase II of its project on insurance contracts. They argued that the Exposure Draft did not give enough guidance to enable them to account for these features. The Board concluded it could not address such features in the short term. The Board noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the Board was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the Board decided the following:~~

- ~~(a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.~~
- ~~(b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39.~~

~~BC23B The Board does not regard criteria such as those described in paragraph BC23A(a) as suitable for the long term, because they can lead to different accounting for contracts that have similar economic effects. However, the Board could not find a more compelling approach to resolve its concerns for the short term. Moreover, although the criteria described in paragraph BC23A(a) may appear imprecise, the Board believes that the criteria would provide a clear answer in the vast majority of cases. Paragraph AG4A gives guidance on the application of those criteria.~~

~~BC23C The Board considered convergence with US GAAP. In US GAAP, the requirements for financial guarantee contracts (other than those covered by US standards specific to the insurance sector) are in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The recognition and measurement requirements of FIN 45 do not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. Some respondents to the Exposure Draft of July 2004 asked the Board to provide a similar exemption. They argued that the requirement to recognise these financial guarantee contracts in separate or individual financial statements would cause costs disproportionate to the likely benefits, given that intragroup transactions are eliminated on consolidation. However, to avoid the omission of material liabilities from separate or individual financial statements, the Board did not create such an exemption.~~

~~BC23D The Board issued the amendments for financial guarantee contracts in August 2005. After those amendments, the recognition and measurement requirements for financial guarantee contracts within the scope of IAS 39 are consistent with FIN 45 in some areas, but differ in others:~~

- ~~(a) Like FIN 45, IAS 39 requires initial recognition at fair value.~~

- (b) ~~IAS 39 requires systematic amortisation, in accordance with IAS 18[#], of the liability recognised initially. This is compatible with FIN 45, though FIN 45 contains less prescriptive requirements on subsequent measurement. Both IAS 39 and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).~~
- (c) ~~Like FIN 45, IAS 39 permits a different treatment for financial guarantee contracts issued by insurers.~~
- (d) ~~Unlike FIN 45, IAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control. However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities.~~

~~BC23E Some respondents to the Exposure Draft of July 2004 asked for guidance on the treatment of financial guarantee contracts by the holder. However, this was beyond the limited scope of the project.~~

~~Contracts to buy or sell a non-financial item— (paragraphs 5–7 and AG10)~~

~~BC24 Before the amendments, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The Board concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative when it (i) can be settled net or by exchanging financial instruments and (ii) is not held for the purpose of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale). In addition, the Board concluded that the notion of when a contract can be settled net should include contracts:—~~

- (a) ~~where the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments;—~~
- (b) ~~for which the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and—~~
- (c) ~~in which the non-financial item that is the subject of the contract is readily convertible to cash.—~~

~~Because practices of settling net or taking delivery of the underlying and selling it within a short period after delivery also indicate that the contracts are not 'normal' purchases or sales, such contracts are within the scope of IAS 39 and are accounted for as derivatives. The Board also decided to clarify that a written option that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of the Standard and cannot qualify as a 'normal' purchase or sale.—~~

~~Business combination forward contracts~~

~~BC24A The Board was advised that there was diversity in practice regarding the application of the exemption in paragraph 2(g) of IAS 39.* Paragraph 2(g) applies to particular contracts~~

[#] ~~IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.~~

^{*} ~~In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which amended paragraph 2(g) to clarify that the exception should only apply to forward contracts that result in a business combination within the scope of IFRS 3 *Business Combinations*.~~

~~associated with a business combination and results in those contracts not being accounted for as derivatives while, for example, necessary regulatory and legal processes are being completed.~~

~~BC24B As part of the *Improvements to IFRSs* issued in April 2009, the Board concluded that paragraph 2(g) should be restricted to forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree in a business combination at a future acquisition date and should not apply to option contracts, whether or not currently exercisable, that on exercise will result in control of an entity.~~

~~BC24C The Board concluded that the purpose of paragraph 2(g) is to exempt from the provisions of IAS 39 contracts for business combinations that are firmly committed to be completed. Once the business combination is consummated, the entity follows the requirements of IFRS 3. Paragraph 2(g) applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time is required). Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.~~

~~BC24D Several respondents to the exposure draft expressed the view that the proposed amendment should also apply to contracts to acquire investments in associates, referring to paragraph 20 of IAS 28. However, the acquisition of an interest in an associate represents the acquisition of a financial instrument. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures. The Board concluded that paragraph 2(g) should not be applied by analogy to contracts to acquire investments in associates and similar transactions. This conclusion is consistent with the conclusion the Board reached regarding impairment losses on investments in associates as noted in the *Improvements to IFRSs* issued in May 2008 and stated in paragraph BC27 of the Basis for Conclusions on IAS 28.~~

~~BC24E Some respondents to the exposure draft raised concerns about the proposed transition requirement. The Board noted that determining the fair value of a currently outstanding contract when its inception was before the effective date of this amendment would require the use of hindsight and might not achieve comparability. Accordingly, the Board decided not to require retrospective application. The Board also rejected applying the amendment prospectively only to new contracts entered into after the effective date because that would create a lack of comparability between contracts outstanding as of the effective date and contracts entered into after the effective date. Therefore, the Board concluded that the amendment to paragraph 2(g) should be applied prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010.~~

~~Definitions~~

~~Loans and receivables (paragraphs 9, 46(a) and AG26)~~

~~BC25 The principal difference between loans and receivables and other financial assets is that loans and receivables are not subject to the tainting provisions that apply to held-to-maturity investments. Loans and receivables that are not held for trading may be measured at amortised cost even if an entity does not have the positive intention and ability to hold the loan asset until maturity.~~

~~BC26 The Board decided that the ability to measure a financial asset at amortised cost without consideration of the entity's intention and ability to hold the asset until maturity is most appropriate when there is no liquid market for the asset. It is less appropriate to extend~~

~~the category to debt instruments traded in liquid markets. The distinction for measurement purposes between liquid debt instruments that are acquired upon issue and liquid debt instruments that are acquired shortly afterwards is difficult to justify on conceptual grounds. Why should a liquid debt instrument that is purchased on the day of issue be treated differently from a liquid debt instrument that is purchased one week after issue? Why should it not be possible to classify a liquid debt instrument that is acquired directly from the issuer as available for sale, with fair value gains and losses recognised in equity? Why should a liquid debt instrument that is bought shortly after it is issued be subject to tainting provisions, if a liquid debt instrument that is bought at the time of issue is not subject to tainting provisions?~~

~~BC27—The Board therefore decided to add a condition to the definition of a loan or receivable. More specifically, an entity should not be permitted to classify as a loan or receivable an investment in a debt instrument that is quoted in an active market. For such an investment, an entity should be required to demonstrate its positive intention and ability to hold the investment until maturity to be permitted to measure the investment at amortised cost by classifying it as held to maturity.~~

~~BC28—The Board considered comments received on the proposal in the Exposure Draft (which was unchanged from the requirement in the original IAS 39) that ‘loans and receivables’ must be originated (rather than purchased) to meet that classification. Such comments suggested that purchased loans should be eligible for classification as loans and receivables, for example, if an entity buys a loan portfolio, and the purchased loans meet the definition other than the fact that they were purchased. Such comments also noted that (a) some entities typically manage purchased and originated loans together, and (b) there are systems problems of segregating purchased loans from originated loans given that a distinction between them is likely to be made only for accounting purposes. In the light of these concerns, the Board decided to remove the requirement that loans or receivables must be originated by the entity to meet the definition of ‘loans and receivables’.~~

~~BC29—However, the Board was concerned that removing this requirement might result in some instruments that should be measured at fair value meeting the definition of loans and receivables and thus being measured at amortised cost. In particular, the Board was concerned that this would be the case for a debt instrument in which the purchaser may not recover its investment, for example a fixed rate interest only strip created in a securitisation and subject to prepayment risk. The Board therefore decided to exclude from the definition of loans and receivables instruments for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration. Such assets are accounted for as available for sale or at fair value through profit or loss.~~

~~Effective interest rate (paragraphs 9 and AG5-AG8)~~

~~BC30—The Board considered whether the effective interest rate for all financial instruments should be calculated on the basis of estimated cash flows (consistently with the original IAS 39) or whether the use of estimated cash flows should be restricted to groups of financial instruments with contractual cash flows being used for individual financial instruments. The Board agreed to reconfirm the position in the original IAS 39 because it achieves consistent application of the effective interest method throughout the Standard.~~

~~BC31—The Board noted that future cash flows and the expected life can be reliably estimated for most financial assets and financial liabilities, in particular for a group of similar financial assets or similar financial liabilities. However, the Board acknowledged that in some rare~~

~~cases it might not be possible to estimate the timing or amount of future cash flows reliably. It therefore decided to require that if it is not possible to estimate reliably the future cash flows or the expected life of a financial instrument, the entity should use contractual cash flows over the full contractual term of the financial instrument.~~

~~BC32 The Board also decided to clarify that expected future defaults should not be included in estimates of cash flows because this would be a departure from the incurred loss model for impairment recognition. At the same time, the Board noted that in some cases, for example, when a financial asset is acquired at a deep discount, credit losses have occurred and are reflected in the price. If an entity does not take into account such credit losses in the calculation of the effective interest rate, the entity would recognise a higher interest income than that inherent in the price paid. The Board therefore decided to clarify that such credit losses are included in the estimated cash flows when computing the effective interest rate.~~

~~BC33 The revised IAS 39 refers to all fees ‘that are an integral part of the effective interest rate’. The Board included this reference to clarify that IAS 39 relates only to those fees that are determined to be an integral part of the effective interest rate in accordance with IAS 18.*~~

~~BC34 Some commentators noted that it was not always clear how to interpret the requirement in the original IAS 39 that the effective interest rate must be based on discounting cash flows through maturity or the next market-based repricing date. In particular, it was not always clear whether fees, transaction costs and other premiums or discounts included in the calculation of the effective interest rate should be amortised over the period until maturity or the period to the next market-based repricing date.~~

~~BC35 For consistency with the estimated cash flows approach, the Board decided to clarify that the effective interest rate is calculated over the expected life of the instrument or, when applicable, a shorter period. A shorter period is used when the variable (eg interest rates) to which the fee, transaction costs, discount or premium relates is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date.~~

~~BC35A The Board identified an apparent inconsistency in the guidance in the revised IAS 39. It related to whether the revised or the original effective interest rate of a debt instrument should be applied when remeasuring the instrument’s carrying amount on the cessation of fair value hedge accounting. A revised effective interest rate is calculated when fair value hedge accounting ceases. The Board removed this inconsistency as part of *Improvements to IFRSs* issued in May 2008 by clarifying that the remeasurement of an instrument in accordance with paragraph AG8 is based on the revised effective interest rate calculated in accordance with paragraph 92, when applicable, rather than the original effective interest rate.~~

~~Accounting for a change in estimates~~

~~BC36 The Board considered the accounting for a change in the estimates used in calculating the effective interest rate. The Board agreed that if an entity revises its estimates of payments or receipts, it should adjust the carrying amount of the financial instrument to reflect actual and revised estimated cash flows. The adjustment is recognised as income or expense in profit or loss. The entity recalculates the carrying amount by computing the~~

*- IFRS 15 Revenue from Contracts with Customers, issued in May 2014, replaced IAS 18 Revenue. The guidance in IAS 18 that related to fees to be included in the effective interest rate was relocated to paragraphs AG8A-AG8B of IAS 39.

~~present value of remaining cash flows at the original effective interest rate of the financial instrument. The Board noted that this approach has the practical advantage that it does not require recalculation of the effective interest rate, ie the entity simply recognises the remaining cash flows at the original rate. As a result, this approach avoids a possible conflict with the requirement when assessing impairment to discount estimated cash flows using the original effective interest rate.~~

~~Embedded derivatives~~

~~Embedded foreign currency derivatives (paragraphs 10 and AG33(d))~~

~~BC37—A rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, a commodity forward in a debt instrument. To achieve consistency in accounting for such embedded derivatives, all derivatives embedded in financial instruments that are not measured at fair value with gains and losses recognised in profit or loss ought to be accounted for separately as derivatives. However, as a practical expedient IAS 39 provides that an embedded derivative need not be separated if it is regarded as closely related to its host contract. When the embedded derivative bears a close economic relationship to the host contract, such as a cap or a floor on the interest rate on a loan, it is less likely that the derivative was embedded to achieve a desired accounting result.~~

~~BC38—The original IAS 39 specified that a foreign currency derivative embedded in a non-financial host contract (such as a supply contract denominated in a foreign currency) was not separated if it required payments denominated in the currency of the primary economic environment in which any substantial party to the contract operates (their functional currencies) or the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (such as the US dollar for crude oil transactions). Such foreign currency derivatives are regarded as bearing such a close economic relationship to their host contracts that they do not have to be separated.~~

~~BC39—The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) rather than the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.~~

~~BC40—In revising IAS 39, the Board concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place. A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for~~

example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperinflationary Economies*).

~~Inability to measure an embedded derivative separately (paragraph 12)~~

~~BC40A As described in paragraph BC11F, the Board also considered another issue related to a reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category. If the fair value of the embedded derivative that would have to be separated cannot be measured separately, the Board decided to clarify that the hybrid (combined) financial asset in its entirety should remain in the fair value through profit or loss category. The Board noted that the clarification to paragraph 12 would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates, and hence avoid a requirement to reclassify the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period. The amendments were issued in March 2009.~~

~~Embedded prepayment penalties (paragraph AG30(g))~~

~~BC40B The Board identified an apparent inconsistency in the guidance in IAS 39. The inconsistency related to embedded prepayment options in which the exercise price represented a penalty for early repayment (ie prepayment) of the loan. The inconsistency related to whether these are considered closely related to the loan.~~

~~BC40C The Board decided to remove this inconsistency by amending paragraph AG30(g). The amendment makes an exception to the examples in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise prices of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.~~

~~Recognition and derecognition—~~

~~Derecognition of a financial asset (paragraphs 15–37)—~~

~~The original IAS 39—~~

~~BC41 Under the original IAS 39, several concepts governed when a financial asset should be derecognised. It was not always clear when and in what order to apply these concepts. As a result, the derecognition requirements in the original IAS 39 were not applied consistently in practice.—~~

~~BC42 As an example, the original IAS 39 was unclear about the extent to which risks and rewards of a transferred asset should be considered for the purpose of determining whether derecognition is appropriate and how risks and rewards should be assessed. In some cases (eg transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (eg credit guarantees) it was unclear. Also, some questioned whether the assessment should focus on risks and~~

~~rewards or only risks and how different risks and rewards should be aggregated and weighed.~~

~~BC43 To illustrate, assume an entity sells a portfolio of short term receivables of CU100^{*} and provides a guarantee to the buyer for credit losses up to a specified amount (say CU20) that is less than the total amount of the receivables, but higher than the amount of expected losses (say CU5). In this case, should (a) the entire portfolio continue to be recognised, (b) the portion that is guaranteed continue to be recognised or (c) the portfolio be derecognised in full and a guarantee be recognised as a financial liability? The original IAS 39 did not give a clear answer and the IAS 39 Implementation Guidance Committee a group set up by the Board's predecessor body to resolve interpretative issues raised in practice was unable to reach an agreement on how IAS 39 should be applied in this case. In developing proposals for improvements to IAS 39, the Board concluded that it was important that IAS 39 should provide clear and consistent guidance on how to account for such a transaction.~~

~~Exposure draft~~

~~BC44 To resolve the problems, the Exposure Draft proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash settled option).~~

~~BC45 The purpose of the approach proposed in the Exposure Draft was to facilitate consistent implementation and application of IAS 39 by eliminating conflicting concepts and establishing an unambiguous, more internally consistent and workable approach to derecognition. The main benefits of the proposed approach were that it would greatly clarify IAS 39 and provide transparency on the face of the balance sheet about any continuing involvement in a transferred asset.~~

~~Comments received~~

~~BC46 Many respondents agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the continuing involvement approach proposed in the Exposure Draft. Respondents expressed conceptual and practical concerns, including:~~

- ~~(a) any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems;~~
- ~~(b) the proposed approach was a fundamental change from that in the original IAS 39;~~
- ~~(c) the proposal did not achieve convergence with US GAAP;~~
- ~~(d) the proposal was untested; and~~
- ~~(e) the proposal was not consistent with the *Framework*.~~

^{*} In this Basis for Conclusions, monetary amounts are denominated in 'currency units' (CU).

~~BC47 Many respondents expressed the view that the basic approach in the original IAS 39 should be retained in the revised Standard and the inconsistencies removed. The reasons included: (a) the existing IAS 39 was proven to be reasonable in concept and operational in practice and (b) the approach should not be changed until the Board developed an alternative comprehensive approach.—~~

~~Revisions to IAS 39—~~

~~BC48 In response to the comments received, the Board decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied. In particular, the Board decided that an evaluation of the transfer of risks and rewards should precede an evaluation of the transfer of control for all types of transactions.—~~

~~BC49 Although the structure and wording of the derecognition requirements have been substantially amended, the Board concluded that the requirements in the revised IAS 39 are not substantially different from those in the original IAS 39. In support of this conclusion, it noted that the application of the requirements in the revised IAS 39 generally results in answers that could have been obtained under the original IAS 39. In addition, although there will be a need to apply judgement to evaluate whether substantially all risks and rewards have been retained, this type of judgement is not new compared with the original IAS 39. However, the revised requirements clarify the application of the concepts in circumstances in which it was previously unclear how IAS 39 should be applied. The Board concluded that it would be inappropriate to revert to the original IAS 39 without such clarifications.—~~

~~BC50 The Board also decided to include guidance in the Standard that clarifies how to evaluate the concepts of risks and rewards and of control. The Board regards such guidance as important to provide a framework for applying the concepts in IAS 39. Although judgement is still necessary to apply the concepts in practice, the guidance should increase consistency in how the concepts are applied.—~~

~~BC51 More specifically, the Board decided that the transfer of risks and rewards should be evaluated by comparing the entity's exposure before and after the transfer to the variability in the amounts and timing of the net cash flows of the transferred asset. If the entity's exposure, on a present value basis, has not changed significantly, the entity would conclude that it has retained substantially all risks and rewards. In this case, the Board concluded that the asset should continue to be recognised. This accounting treatment is consistent with the treatment of repurchase transactions and some assets subject to deep in the money options under the original IAS 39. It is also consistent with how some interpreted the original IAS 39 when an entity sells a portfolio of short term receivables but retains all substantive risks through the issue of a guarantee to compensate for all expected credit losses (see the example in paragraph BC43).—~~

~~BC52 The Board decided that control should be evaluated by looking to whether the transferee has the practical ability to sell the asset. If the transferee can sell the asset (eg because the asset is readily obtainable in the market and the transferee can obtain a replacement asset should it need to return the asset to the transferor), the transferor has not retained control because the transferor does not control the transferee's use of the asset. If the transferee cannot sell the asset (eg because the transferor has a call option and the asset is not readily obtainable in the market, so that the transferee cannot obtain a replacement asset), the transferor has retained control because the transferee is not free to use the asset as its own.—~~

~~BC53 The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue. It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset is considered for derecognition only if it comprises:—~~

- ~~(a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);—~~
- ~~(b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or—~~
- ~~(c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).—~~

~~— In all other cases the derecognition principles are applied to the financial asset in its entirety.—~~

~~Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 19)—~~

~~BC54 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a ‘pass through arrangement’). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.—~~

~~BC55 To illustrate the issue using a simple example, assume the following. Entity A makes a five year interest bearing loan (the ‘original asset’) of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?*~~

~~BC56 To address these issues, the Exposure Draft of proposed amendments to IAS 39 included guidance to clarify under which conditions passthrough arrangements can be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the *Framework*, when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for~~

* — SIC 12 *Consolidation – Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.—

BC57— Respondents to the Exposure Draft were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC 12 *Consolidation—Special Purpose Entities*). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.—

BC58— Considering these and other comments, the Board decided to proceed with its proposals to issue guidance on pass through arrangements and to clarify that guidance in finalising the revised IAS 39.—

BC59— The Board concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:

- (a) — The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.—
- (b) — The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.—
- (c) — The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.—

BC60— These conditions follow from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).—

BC61— The Board decided that the derecognition tests that apply to other transfers of financial assets (ie the tests of transferring substantially all the risks and rewards and control) should also apply to arrangements to pass through cash flows that meet the three conditions but do not involve a fully proportional share of all or specifically identified cash flows. Thus, if the three conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BC55) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, in the example in paragraph BC55, Entity A would report a loan asset of CU10 and derecognise CU90. Similarly, if an entity enters into an arrangement that meets the three conditions above, but the arrangement is not on a fully proportionate basis, the contractual arrangement would have to meet the general derecognition conditions to qualify for derecognition. This ensures consistency in the application of the derecognition model, whether a transaction is structured as a transfer of the contractual right to receive the cash flows of a financial asset or as an arrangement to pass through cash flows.—

~~BC62 To illustrate a disproportionate arrangement using a simple example, assume the following. Entity A originates a portfolio of five year interest bearing loans of CU10,000. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A retains rights to the last CU1,000 (plus interest), ie it retains a subordinated residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000 because some debtors default, Entity A would pass on to Entity C all of the CU8,000 collected and Entity A keeps nothing of the CU8,000 collected. If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500. In this case, if Entity A retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows, the loans continue to be recognised in their entirety even if the three pass through conditions are met.~~

~~BC63 The Board recognises that many securitisations may fail to qualify for derecognition either because one or more of the three conditions in paragraph 19 are not met or because the entity has retained substantially all the risks and rewards of ownership.~~

~~BC64 Whether a transfer of a financial asset qualifies for derecognition does not differ depending on whether the transfer is direct to investors or through a consolidated SPE or trust that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors.~~

~~Transfers that do not qualify for derecognition (paragraph 29)~~

~~BC65 The original IAS 39 did not provide guidance about how to account for a transfer of a financial asset that does not qualify for derecognition. The amendments include such guidance. To ensure that the accounting reflects the rights and obligations that the transferor has in relation to the transferred asset, there is a need to consider the accounting for the asset as well as the accounting for the associated liability.~~

~~BC66 When an entity retains substantially all the risks and rewards of the asset (eg in a repurchase transaction), there are generally no special accounting considerations because the entity retains upside and downside exposure to gains and losses resulting from the transferred asset. Therefore, the asset continues to be recognised in its entirety and the proceeds received are recognised as a liability. Similarly, the entity continues to recognise any income from the asset along with any expense incurred on the associated liability.~~

~~Continuing involvement in a transferred asset (paragraphs 30-35)~~

~~BC67 The Board decided that if the entity determines that it has neither retained nor transferred substantially all of the risks and rewards of an asset and that it has retained control, the entity should continue to recognise the asset to the extent of its continuing involvement. This is to reflect the transferor's continuing exposure to the risks and rewards of the asset and that this exposure is not related to the entire asset, but is limited in amount. The Board noted that precluding derecognition to the extent of the continuing involvement is useful to users of financial statements in such cases, because it reflects the entity's retained exposure to the risks and rewards of the financial asset better than full derecognition.~~

~~BC68 When the entity transfers some significant risks and rewards and retains others and derecognition is precluded because the entity retains control of the transferred asset, the entity no longer retains all the upside and downside exposure to gains and losses resulting from the transferred asset. Therefore, the revised IAS 39 requires the asset and the associated liability to be measured in a way that ensures that any changes in value of the transferred asset that are not attributed to the entity are not recognised by the entity.~~

~~BC69 For example, special measurement and income recognition issues arise if derecognition is precluded because the transferor has retained a call option or written a put option and the asset is measured at fair value. In those situations, in the absence of additional guidance, application of the general measurement and income recognition requirements for financial assets and financial liabilities in IAS 39 may result in accounting that does not represent the transferor's rights and obligations related to the transfer.~~

~~BC70 As another example, if the transferor retains a call option on a transferred available-for-sale financial asset and the fair value of the asset decreases below the exercise price, the transferor does not suffer a loss because it has no obligation to exercise the call option. In that case, the Board decided that it is appropriate to adjust the measurement of the liability to reflect that the transferor has no exposure to decreases in the fair value of the asset below the option exercise price. Similarly, if a transferor writes a put option and the fair value of the asset exceeds the exercise price, the transferee need not exercise the put. Because the transferor has no right to increases in the fair value of the asset above the option exercise price, it is appropriate to measure the asset at the lower of (a) the option exercise price and (b) the fair value of the asset.~~

~~Measurement~~

~~Definitions (paragraph 9)~~

~~BC70A The definition of a financial asset or financial liability at fair value through profit or loss excludes derivatives that are designated and effective hedging instruments. Paragraph 50 of IAS 39 prohibits the reclassification of financial instruments into or out of the fair value through profit or loss category after initial recognition. The Board noted that the prohibition on reclassification in paragraph 50 might be read as preventing a derivative financial instrument that becomes a designated and effective hedging instrument from being excluded from the fair value through profit or loss category in accordance with the definition. Similarly, it might be read as preventing a derivative that ceases to be a designated and effective hedging instrument from being accounted for at fair value through profit or loss.~~

~~BC70B The Board decided that the prohibition on reclassification in paragraph 50 should not prevent a derivative from being accounted for at fair value through profit or loss when it does not qualify for hedge accounting and vice versa. Therefore, in *Improvements to IFRSs* issued in May 2008, the Board amended the definitions in paragraph 9(a) and added paragraph 50A to address this point.~~

~~Fair value option (paragraph 9)~~

~~BC71 The Board concluded that it could simplify the application of IAS 39 (as revised in 2000) for some entities by permitting the use of fair value measurement for any financial instrument. With one exception (see paragraph 9), this greater use of fair value is optional. The fair value measurement option does not require entities to measure more financial instruments at fair value.~~

~~BC72 IAS 39 (as revised in 2000) did not permit an entity to measure particular categories of financial instruments at fair value with changes in fair value recognised in profit or loss. Examples included:—~~

- ~~(a) — originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading in paragraph 9.—~~
- ~~(b) — financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available for sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading in paragraph 9.—~~
- ~~(c) — non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.—~~

~~BC73 The Board decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss ('fair value through profit or loss'). To impose discipline on this approach, the Board decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. The Board noted that the requirement to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to 'cherry pick' in this way. This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.—~~

~~BC73A Following the issue of IAS 39 (as revised in 2003), as a result of continuing discussions with constituents on the fair value option, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately (as discussed in paragraph BC11C). In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003). After discussing comments received from constituents and a series of public round table meetings, the Board issued an amendment to IAS 39 in June 2005 permitting entities to designate irrevocably on initial recognition financial instruments that meet one of three conditions (see paragraphs 9(b)(i), 9(b)(ii) and 11A) as ones to be measured at fair value through profit or loss.—~~

~~BC74 In the amendment to the fair value option, the Board identified three situations in which permitting designation at fair value through profit or loss either results in more relevant information (cases (a) and (b) below) or is justified on the grounds of reducing complexity or increasing measurement reliability (case (c) below). These are:—~~

- ~~(a) — when such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise (paragraphs BC75–BC75B);—~~
- ~~(b) — when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraphs BC76–BC76B); and—~~

- (e) ~~when an instrument contains an embedded derivative that meets particular conditions (paragraphs BC77-BC78).~~

~~BC74A The ability for entities to use the fair value option simplifies the application of IAS 39 by mitigating some anomalies that result from the different measurement attributes in the Standard. In particular, for financial instruments designated in this way:~~

- (a) ~~it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analysing hedge effectiveness.~~
- (b) ~~it eliminates the burden of separating embedded derivatives.~~
- (c) ~~it eliminates problems arising from a mixed measurement model when financial assets are measured at fair value and related financial liabilities are measured at amortised cost. In particular, it eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently.~~
- (d) ~~the option to recognise unrealised gains and losses on available for sale financial assets in profit or loss is no longer necessary.~~
- (e) ~~it de-emphasises interpretative issues around what constitutes trading.~~

~~Designation as at fair value through profit or loss eliminates or significantly reduces a measurement or recognition inconsistency (paragraph 9(b)(i))~~

~~BC75 IAS 39, like comparable standards in some national jurisdictions, imposes a mixed attribute measurement model. It requires some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It requires some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity.* This combination of measurement and recognition requirements can result in inconsistencies, which some refer to as ‘accounting mismatches’, between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.~~

~~BC75A Some entities can overcome measurement or recognition inconsistencies by using hedge accounting or, in the case of insurers, shadow accounting. However, the Board recognises that those techniques are complex and do not address all situations. In developing the amendment to the fair value option, the Board considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.~~

*—As a consequence of the revision of IAS 1 Presentation of Financial Statements in 2007 these other gains and losses are recognised in other comprehensive income.

~~BC75B The Board concluded that accounting mismatches arise in a wide variety of circumstances. In the Board's view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the Board concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. Hence, the Board decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option. Rather, the Board decided to require disclosures in IAS 32^{*} about:~~

- ~~• the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss~~
- ~~• how the entity satisfies the conditions in this Standard for such designation~~
- ~~• the nature of the assets and liabilities so designated~~
- ~~• the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability's credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.~~

~~**A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraph 9(b)(ii))**~~

~~BC76 The Standard requires financial instruments to be measured at fair value through profit or loss in only two situations, namely when an instrument is held for trading or when it contains an embedded derivative that the entity is unable to measure separately. However, the Board recognised that some entities manage and evaluate the performance of financial instruments on a fair value basis in other situations. Furthermore, for instruments managed and evaluated in this way, users of financial statements may regard fair value measurement as providing more relevant information. Finally, it is established practice in some industries in some jurisdictions to recognise all financial assets at fair value through profit or loss. (This practice was permitted for many assets in IAS 39 (as revised in 2000) as an accounting policy choice in accordance with which gains and losses on all available for sale financial assets were reported in profit or loss.)~~

~~BC76A In the amendment to IAS 39 relating to the fair value option issued in June 2005, the Board decided to permit financial instruments managed and evaluated on a fair value basis to be measured at fair value through profit or loss. The Board also decided to introduce two requirements to make this category operational. These requirements are that the financial instruments are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and that information about the financial instruments is provided internally on that basis to the entity's key management personnel.~~

^{*} In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

~~BC76B~~ In looking to an entity's documented risk management or investment strategy, the Board makes no judgement on what an entity's strategy should be. However, the Board noted that users, in making economic decisions, would find useful both a description of the chosen strategy and how designation at fair value through profit or loss is consistent with it. Accordingly, IAS 32^{*} requires such disclosures. The Board also noted that the required documentation of the entity's strategy need not be on an item-by-item basis, nor need it be in the level of detail required for hedge accounting. However, it should be sufficient to demonstrate that using the fair value option is consistent with the entity's risk management or investment strategy. In many cases, the entity's existing documentation, as approved by its key management personnel, should be sufficient for this purpose.

~~The instrument contains an embedded derivative that meets particular conditions (paragraph 11A)–~~

~~BC77~~ The Standard requires virtually all derivative financial instruments to be measured at fair value. This requirement extends to derivatives that are embedded in an instrument that also includes a non-derivative host contract if the embedded derivative meets the conditions in paragraph 11. Conversely, if the embedded derivative does not meet those conditions, separate accounting with measurement of the embedded derivative at fair value is prohibited. Therefore, to satisfy these requirements, the entity must:

- ~~(a)—— identify whether the instrument contains one or more embedded derivatives,–~~
- ~~(b)—— determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and–~~
- ~~(c)—— if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.~~

~~BC77A~~ For some embedded derivatives, like the prepayment option in an ordinary residential mortgage, this process is fairly simple. However, entities with more complex instruments have reported that the search for and analysis of embedded derivatives (steps (a) and (b) in paragraph BC77) significantly increase the cost of complying with the Standard. They report that this cost could be eliminated if they had the option to fair value the combined contract.

~~BC77B~~ Other entities report that one of the most common uses of the fair value option is likely to be for structured products that contain several embedded derivatives. Those structured products will typically be hedged with derivatives that offset all (or nearly all) of the risks they contain, whether or not the embedded derivatives that give rise to those risks are separated for accounting purposes. Hence, the simplest way to account for such products is to apply the fair value option so that the combined contract (as well as the derivatives that hedge it) is measured at fair value through profit or loss. Furthermore, for these more complex instruments, the fair value of the combined contract may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that IAS 39 requires to be separated.–

~~BC78~~ The Board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions of this Standard and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The Board determined that allowing the fair value option to be used for any instrument with an embedded derivative would make other restrictions on the use of the option ineffective;

^{*}—— In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. Therefore, the Board decided to specify situations in which an entity cannot justify using the fair value option in place of assessing embedded derivatives—when the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or is one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

The role of prudential supervisors

~~BC78A~~ The Board considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The Board recognised that regulated financial institutions are extensive holders and issuers of financial instruments and so are likely to be among the largest potential users of the fair value option. However, the Board noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.

~~BC79~~ The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.

~~BC79A~~ The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the Board agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the Board decided to require an entity to disclose how it has satisfied the conditions in paragraphs 9(b), 11A and 12 for using the fair value option, including, for instruments within paragraph 9(b)(ii), a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Other matters

~~BC80~~ IAS 39 (as revised in 2000) contained an accounting policy choice for the recognition of gains and losses on available for sale financial assets—such gains and losses could be recognised either in equity or in profit or loss. The Board concluded that the fair value option removed the need for such an accounting policy choice. An entity can achieve recognition of gains and losses on such assets in profit or loss in appropriate cases by using the fair value option. Accordingly, the Board decided that the choice that was in IAS 39 (as revised in 2000) should be removed and that gains and losses on available for sale financial assets should be recognised in equity when IAS 39 was revised in 2003.

- ~~BC80A The fair value option permits (but does not require) entities to measure financial instruments at fair value with changes in fair value recognised in profit or loss. Accordingly, it does not restrict an entity's ability to use other accounting methods (such as amortised cost). Some respondents to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 would have preferred more pervasive changes to expand the use of fair values and limit the choices available to entities, such as the elimination of the held-to-maturity category or the cash flow hedge accounting approach. Although such changes have the potential to make the principles in IAS 39 more coherent and less complex, the Board did not consider such changes as part of the project to improve IAS 39.~~
- ~~BC81 Comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 also questioned the proposal that all items measured at fair value through profit or loss should have the descriptor 'held for trading'. Some comments noted that 'held for trading' is commonly used with a narrower meaning, and it may be confusing for users if instruments designated at fair value through profit or loss are also called 'held for trading'. Therefore, the Board considered using a fifth category of financial instruments 'fair value through profit or loss' to distinguish those instruments to which the fair value option was applied from those classified as held for trading. The Board rejected this possibility because it believed adding a fifth category of financial instruments would unnecessarily complicate the Standard. Rather, the Board concluded that 'fair value through profit or loss' should be used to describe a category that encompasses financial instruments classified as held for trading and those to which the fair value option is applied.~~
- ~~BC82 In addition, the Board decided to include a requirement for an entity to classify a financial liability as held for trading if it is incurred principally for the purpose of repurchasing it in the near term or it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking. In these circumstances, the absence of a requirement to measure such financial liabilities at fair value permits cherry-picking of unrealised gains or losses. For example, if an entity wishes to recognise a gain, it can repurchase a fixed rate debt instrument that was issued in an environment where interest rates were lower than in the reporting period and if it wishes to recognise a loss, it can repurchase an issued debt instrument that was issued in an environment in which interest rates were higher than in the reporting period. However, a financial liability is not classified as held for trading merely because it funds assets that are held for trading.~~
- ~~BC83 The Board decided to include in revised IAS 32^{*} a requirement to disclose the settlement amount repayable at maturity of a liability that is designated as at fair value through profit or loss. This gives users of financial statements information about the amount owed by the entity to its creditors in the event of its liquidation.~~
- ~~BC84 The Board also decided to include in IAS 39 (as revised in 2003) the ability for entities to designate a loan or receivable as available for sale (see paragraph 9). The Board decided that, in the context of the existing mixed measurement model, there are no reasons to limit to any particular type of asset the ability to designate an asset as available for sale.~~

^{*} — In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

~~Application of the fair value option to a component or a proportion (rather than the entirety) of a financial asset or a financial liability~~

- ~~BC85~~ Some comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value option should be extended so that it could also be applied to a component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).
- ~~BC86~~ The Board concluded that IAS 39 should not extend the fair value option to components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the component because of ordering issues and joint effects (ie if the component is affected by more than one risk, it may be difficult to isolate accurately and measure the component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value adjustment for a component may move the carrying amount of an instrument away from its fair value. In finalising the 2003 amendments to IAS 39, the Board separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC 145).
- ~~BC86A~~ Other comments received on the April 2004 Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The Board was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, CU10 million specified certificates, the first (or last) 10 million certificates to be redeemed, or on some other basis? The Board was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to 'cherry pick' (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the Board decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability. However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency, as explained in paragraph AG4G). Thus, in the above example, the entity could designate CU10 million specified certificates if to do so would meet one of the three criteria in paragraph BC74.

Credit risk of liabilities

- ~~BC87~~ The Board discussed the issue of including changes in the credit risk of a financial liability in its fair value measurement. It considered responses to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 that expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the Board concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in the Standard (as revised in 2003) because to do so would negate some of the benefits of the fair value option set out in paragraph BC74A.

~~BC88—The Board considered comments on the Exposure Draft that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and a loan expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when a liability's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in the instrument's credit risk.—~~

~~BC89—However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability[#] reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:—~~

- ~~(a)—entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;—~~
- ~~(b)—changes in credit risk affect the observed market price of a financial liability and hence its fair value;—~~
- ~~(c)—it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and—~~
- ~~(d)—the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.—~~

~~BC90—The Board also considered whether the component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that whilst separately presenting or disclosing such changes might be difficult in practice, disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided to include in IAS 32^{*} a disclosure to help identify the changes in the fair value of a financial liability that arise from changes in the liability's credit risk. The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.—~~

~~BC91—The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity. The Board noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.[†]—~~

~~BC92—The Board also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.—~~

~~BC92A IFRS 13, issued in May 2011, includes requirements for measuring the fair value of a liability issued with an inseparable third party credit enhancement from the issuer's perspective.—~~

[#]—IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

^{*}—In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

[†]—IFRS 13, issued in May 2011, describes the objective of a fair value measurement of a liability.

~~Measurement of financial liabilities with a demand feature*~~~~BC93–BC94 [Deleted]~~**~~Fair value measurement guidance
(paragraphs AG69–AG82)[#]~~**~~BC95 The Board decided to include in the revised IAS 39 expanded guidance about how to determine fair values, in particular for financial instruments for which no quoted market price is available (Appendix A paragraphs AG74–AG82).[†] The Board decided that it is desirable to provide clear and reasonably detailed guidance about the objective and use of valuation techniques to achieve reliable and comparable fair value estimates when financial instruments are measured at fair value.~~**~~Use of quoted prices in active markets (paragraphs AG71–AG73)~~**~~BC96 The Board considered comments received that disagreed with the proposal in the Exposure Draft that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market. Some respondents argued that (a) valuation techniques are more appropriate for measuring fair value than a quoted price in an active market (eg for derivatives) and (b) valuation models are consistent with industry best practice, and are justified because of their acceptance for regulatory capital purposes.~~~~BC97 However, the Board confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value as defined in the Standard does not depend on entity-specific factors. The Board further clarified that a quoted price includes market-quoted rates as well as prices.~~**~~Entities that have access to more than one active market (paragraph AG71)~~**~~BC98 The Board considered situations in which entities operate in different markets. An example is a trader that originates a derivative with a corporate in an active corporate retail market and offsets the derivative by taking out a derivative with a dealer in an active dealers' wholesale market. The Board decided to clarify that the objective of fair value measurement is to arrive at the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market^{*} to which an entity has immediate access. Thus, if a dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers' market, the entity recognises a profit on initial recognition of the derivative instrument. However, the entity adjusts the price observed in the dealer market for any differences in counterparty credit risk between the derivative instrument with the corporate and that with the dealers' market.~~

^{*}— IFRS 13, issued in May 2011, resulted in the relocation of paragraphs BC93 and BC94 of IAS 39 to paragraphs BCZ102 and BCZ103 of IFRS 13. As a consequence minor necessary edits have been made to that material.

[#]— IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

[†]— IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence in Appendix A of IAS 39 paragraphs AG69–AG75, AG76A–AG79 and AG82 have been deleted and paragraphs AG76, AG80 and AG81 have been amended. *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, added paragraph BC138A to the Basis for Conclusions on IFRS 13 to clarify the IASB's reason for deleting paragraph AG79.

^{*}— IFRS 13, issued in May 2011, states that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market, or in the absence of a principal market, the most advantageous market for the asset or liability.

~~Bid-ask spreads in active markets (paragraph AG72)–~~

~~BC99 The Board confirmed the proposal in the Exposure Draft that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price.[#] It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising up-front gains or losses for the difference between the bid-ask price and the mid-market price.–~~

~~BC100 The Board discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.⁺–~~

~~BC101 Comments received on the Exposure Draft revealed that some interpret the term ‘bid-ask spread’ differently from others and from the Board. Thus, IAS 39 clarifies that the spread represents only transaction costs.–~~

~~No active market (paragraphs AG74–AG82)–~~

~~BC102 The Exposure Draft proposed a three-tier fair value measurement hierarchy as follows:–~~

- ~~(a) For instruments traded in active markets, use a quoted price.–~~
- ~~(b) For instruments for which there is not an active market, use a recent market transaction.–~~
- ~~(c) For instruments for which there is neither an active market nor a recent market transaction, use a valuation technique.–~~

~~BC103 The Board decided to simplify the proposed fair value measurement hierarchy* by requiring the fair value of financial instruments for which there is not an active market to be determined on the basis of valuation techniques, including the use of recent market transactions between knowledgeable, willing parties in an arm’s length transaction.–~~

~~BC104 The Board also considered constituents’ comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising up-front gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value.[#] The Board also noted that its decision achieved convergence with US GAAP.⁺–~~

[#] IFRS 13, issued in May 2011, states that fair value is measured using the price within the bid-ask spread that is most representative of fair value in the circumstances.

⁺ IFRS 13, issued in May 2011, permits an exception to the fair value measurement requirements when an entity manages its financial assets and financial liabilities on the basis of the entity’s net exposure to market risks or the credit risk of a particular counterparty, allowing the entity to measure the fair value of its financial instruments on the basis of the entity’s net exposure to either of those risks.

^{*} IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value.

[#] IFRS 13, issued in May 2011, describes when a transaction price might not represent the fair value of an asset or a liability at initial recognition.

⁺ FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) superseded EITF Issue No.

Reclassification of financial instruments

~~BC104A As described in paragraph BC11E, in October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP. SFAS 115 permits a security to be reclassified out of the trading category in rare situations. SFAS 65 permits a loan to be reclassified out of the Held for Sale category if the entity has the intention and ability to hold the loan for the foreseeable future or until maturity. IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held for trading category as is permitted by SFAS 115 and SFAS 65.~~

~~BC104B The Board noted that allowing reclassification, even in limited circumstances, could allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets.~~

~~BC104C The Board was also informed that, in practice under US GAAP, reclassification out of the trading category of SFAS 115 is extremely rare. However, the Board noted that the possibility of reclassification of securities and loans under US GAAP is available and that entities applying IFRSs do not have that possibility.~~

~~BC104D The Board therefore decided to permit non-derivative financial assets to be reclassified out of the held for trading category in the same circumstances as are permitted in SFAS 115 and SFAS 65. The Board also noted that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term. In addition, the Board decided that a financial asset that would have met the definition of loans and receivables (if it had not been designated as available for sale) should be permitted to be transferred from the available for sale category to loans and receivables, if the entity intends to hold the loan or receivable for the foreseeable future or until maturity. The Board decided that this substantially aligns the accounting for reclassifications of loans and receivables with that permitted under US GAAP.~~

~~BC104E The Board normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, given the requests to address this issue urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to proceed directly to issuing the amendments. In taking this exceptional step the Board noted that the amendments to IAS 39 relaxed the existing requirements to provide short-term relief for some entities. The Board also noted that the amendments were a short-term response to the requests and therefore the Board decided to restrict the scope of the amendments. Shortly afterwards, in response to representations from some interested parties, the Board issued a further amendment clarifying the effective date of the amendments to IAS 39.~~

Impairment and uncollectibility of financial assets—

Impairment of investments in equity instruments (paragraph 61)—

~~BC105 Under IAS 39, investments in equity instruments that are classified as available for sale and investments in unquoted equity instruments* whose fair value cannot be reliably measured are subject to an impairment assessment. The original IAS 39 did not include guidance about impairment indicators that are specific to investments in equity instruments. Questions were raised about when in practice such investments become impaired.~~

~~BC106 The Board agreed that for marketable investments in equity instruments any impairment~~

02-3 Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Involved in Energy Trading and Risk Management Activities (Topic 820 Fair Value Measurement in the FASB Accounting Standards Codification—codified SFAS 157). As a result, IFRSs and US GAAP have different requirements for when an entity may recognise a gain or loss when there is a difference between fair value and the transaction price at initial recognition.*

*—IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.—

trigger other than a decline in fair value below cost is likely to be arbitrary to some extent. If markets are reasonably efficient, today's market price is the best estimate of the discounted value of the future market price. However, the Board also concluded that it is important to provide guidance to address the questions raised in practice.—

~~BC107 The revised IAS 39 includes impairment triggers that the Board concluded were reasonable in the case of investments in equity instruments (paragraph 61). They apply in addition to those specified in paragraph 59, which focus on the assessment of impairment in debt instruments.—~~

~~Incurring versus expected losses—~~

~~BC108 Some respondents to the Exposure Draft were confused about whether the Exposure Draft reflected an 'incurred loss' model or an 'expected loss' model. Others expressed concern about the extent to which 'future losses' could be recognised as impairment losses. They suggested that losses should be recognised only when they are incurred (ie a deterioration in the credit quality of an asset or a group of assets after their initial recognition). Other respondents favoured the use of an expected loss approach. They suggested that expected future losses should be considered in the determination of the impairment loss for a group of assets even if the credit quality of a group of assets has not deteriorated from original expectations.—~~

~~BC109 In considering these comments, the Board decided that impairment losses should be recognised only if they have been incurred. The Board reasoned that it was inconsistent with an amortised cost model to recognise impairment on the basis of expected future transactions and events. The Board also decided that guidance should be provided about what 'incurred' means when assessing whether impairment exists in a group of financial assets. The Board was concerned that, in the absence of such guidance, there could be a range of interpretations about when a loss is incurred or what events cause a loss to be incurred in a group of assets.—~~

~~BC110 Therefore, the Board included guidance in IAS 39 that specifies that for a loss to be incurred, an event that provides objective evidence of impairment must have occurred after the initial recognition of the financial asset, and IAS 39 now identifies types of such events. Possible or expected future trends that may lead to a loss in the future (eg an expectation that unemployment will rise or a recession will occur) do not provide objective evidence of impairment. In addition, the loss event must have a reliably measurable effect on the present value of estimated future cash flows and be supported by current observable data.—~~

~~*Assets assessed individually and found not to be impaired (paragraphs 59(f) and 64)—*~~

~~BC111 It was not clear in the original IAS 39 whether loans and receivables and some other financial assets, when reviewed for impairment and determined not to be impaired, could or should subsequently be included in the assessment of impairment for a group of financial assets with similar characteristics.—~~

~~BC112 The Exposure Draft proposed that a loan asset or other financial asset that is measured at amortised cost and has been individually assessed for impairment and found not to be impaired should be included in a collective assessment of impairment. The Exposure Draft also included proposed guidance about how to evaluate impairment inherent in a group of financial assets.—~~

~~BC113 The comment letters received on the Exposure Draft indicated considerable support for the proposal to include in a collective evaluation of impairment an individually assessed financial asset that is found not to be impaired.—~~

~~BC114 The Board noted the following arguments in favour of an additional portfolio assessment for individually assessed assets that are found not to be impaired.—~~

- (a) ~~Impairment that cannot be identified with an individual loan may be identifiable on a portfolio basis. The *Framework*^{*} states that for a large population of receivables, some degree of non payment is normally regarded as probable. In that case, an expense representing the expected reduction in economic benefits is recognised (*Framework*, paragraph 85).[#] For example, a lender may have some concerns about identified loans with similar characteristics, but not have sufficient evidence to conclude that an impairment loss has occurred on any of those loans on the basis of an individual assessment. Experience may indicate that some of those loans are impaired even though an individual assessment may not reveal this. The amount of loss in a large population of items can be estimated on the basis of experience and other factors by weighting all possible outcomes by their associated probabilities.~~
- (b) ~~Some time may elapse between an event that affects the ability of a borrower to repay a loan and actual default of the borrower. For example, if the market forward price for wheat decreases by 10 per cent, experience may indicate that the estimated payments from borrowers that are wheat farmers will decrease by 1 per cent over a one year period. When the forward price decreases, there may be no objective evidence that any individual wheat farmer will default on an individually significant loan. On a portfolio basis, however, the decrease in the forward price may provide objective evidence that the estimated future cash flows on loans to wheat farmers have decreased by 1 per cent over a one year period.~~
- (c) ~~Under IAS 39, impairment of loans is measured on the basis of the present value of estimated future cash flows. Estimations of future cash flows may change because of economic factors affecting a group of loans, such as country and industry factors, even if there is no objective evidence of impairment of an individual loan. For example, if unemployment increases by 10 per cent in a quarter in a particular region, the estimated future cash flows from loans to borrowers in that region for the next quarters may have decreased even though no objective evidence of impairment exists that is based on an individual assessment of loans to borrowers in that region. In that case, objective evidence of impairment exists for the group of financial assets, even though it does not exist for an individual asset. A requirement for objective evidence to exist to recognise and measure impairment in individually significant loans might result in delayed recognition of loan impairment that has already occurred.~~
- (d) ~~Accepted accounting practice in some countries is to establish a provision to cover impairment losses that, although not specifically identified to individual assets, are known from experience to exist in a loan portfolio as of the balance sheet date.~~
- (e) ~~If assets that are individually not significant are collectively assessed for impairment and assets that are individually significant are not, assets will not be measured on a consistent basis because impairment losses are more difficult to identify asset by asset.~~
- (f) ~~What is an individually significant loan that is assessed on its own will differ from one entity to another. Thus, identical exposures will be evaluated on different bases (individually or collectively), depending on their significance to the entity holding them. If a collective evaluation were not to be required, an entity that wishes to minimise its recognised impairment losses could elect to assess all loans individually. Requiring a collective assessment of impairment for all exposures judged not to be impaired individually enhances consistency between entities rather than reduces it.~~

^{*} References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

[#] now paragraph 4.40 of the *Conceptual Framework*

~~BC115 Arguments against an additional portfolio assessment for individually assessed loans that are found not to be impaired are as follows.—~~

- ~~(a) — It appears illogical to make an impairment provision on a group of loans that have been assessed for impairment on an individual basis and have been found not to be impaired.—~~
- ~~(b) — The measurement of impairment should not depend on whether a lender has only one loan or a group of similar loans. If the measurement of impairment is affected by whether the lender has groups of similar loans, identical loans may be measured differently by different lenders. To ensure consistent measurement of identical loans, impairment in individually significant financial assets should be recognised and measured asset by asset.—~~
- ~~(c) — The *Framework* specifies that financial statements are prepared on the accrual basis of accounting, according to which the effects of transactions and events are recognised when they occur and are recognised in the financial statements in the periods to which they relate. Financial statements should reflect the outcome of events that took place before the balance sheet date and should not reflect events that have not yet occurred. If an impairment loss cannot be attributed to a specifically identified financial asset or a group of financial assets that are not individually significant, it is questionable whether an event has occurred that justifies the recognition of impairment. Even though the risk of loss may have increased, a loss has not yet materialised.—~~
- ~~(d) — The *Framework*, paragraph 94,* requires an expense to be recognised only if it can be measured reliably. The process of estimating impairment in a group of loans that have been individually assessed for impairment but found not to be impaired may involve a significant degree of subjectivity. There may be a wide range of reasonable estimates of impairment. In practice, the establishment of general loan loss provisions is sometimes viewed as more of an art than a science. This portfolio approach should be applied only if it is necessary on practical grounds and not to override an assessment made on an individual loan, which must provide a better determination of whether an allowance is necessary.—~~
- ~~(e) — IAS 39 requires impairment to be measured on a present value basis using the original effective interest rate. Mechanically, it may not be obvious how to do this for a group of loans with similar characteristics that have different effective interest rates. In addition, measurement of impairment in a group of loans based on the present value of estimated cash flows discounted using the original effective interest rate may result in double counting of losses that were expected on a portfolio basis when the loans were originated because the lender included compensation for those losses in the contractual interest rate charged. As a result, a portfolio assessment of impairment may result in the recognition of a loss almost as soon as a loan is issued. (This question arises also in measuring impairment on a portfolio basis for loans that are not individually assessed for impairment under IAS 39.)—~~

~~BC116 The Board was persuaded by the arguments in favour of a portfolio assessment for individually assessed assets that are found not to be impaired and decided to confirm that a loan or other financial asset measured at amortised cost that is individually assessed for impairment and found not to be impaired should be included in a group of similar~~

* — now paragraph 4.49 of the *Conceptual Framework*

financial assets that are assessed for impairment on a portfolio basis. This is to reflect that, in the light of the law of large numbers, impairment may be evident in a group of assets, but not yet meet the threshold for recognition when any individual asset in that group is assessed. The Board also confirmed that it is important to provide guidance about how to assess impairment on a portfolio basis to introduce discipline into a portfolio assessment. Such guidance promotes consistency in practice and comparability of information across entities. It should also mitigate concerns that collective assessments of impairment should not be used to conceal changes in asset values or as a cushion for potential future losses.—

~~BC117 Some respondents expressed concerns about some of the detailed guidance proposed in the Exposure Draft, such as the guidance about adjusting the discount rate for expected losses. Many entities indicated that they do not have the data and systems necessary to implement the proposed approach. The Board decided to eliminate some of the detailed application guidance (eg whether to make an adjustment of the discount rate for originally expected losses and an illustration of the application of the guidance).—~~

Assets that are assessed individually and found to be impaired (paragraph 64)—

~~BC118 In making a portfolio assessment of impairment, one issue that arises is whether the collective assessment should include assets that have been individually evaluated and identified as impaired.—~~

~~BC119 One view is that methods used to estimate impairment losses on a portfolio basis are equally valid whether or not an asset has been specifically identified as impaired. Those who support this view note that the law of large numbers applies equally whether or not an asset has been individually identified as impaired and that a portfolio assessment may enable a more accurate prediction to be made of estimated future cash flows.—~~

~~BC120 Another view is that there should be no need to complement an individual assessment of impairment for an asset that is specifically identified as impaired by an additional portfolio assessment, because objective evidence of impairment exists on an individual basis and expectations of losses can be incorporated in the measurement of impairment for the individual assets. Double counting of losses in terms of estimated future cash flows should not be permitted. Moreover, recognition of impairment losses for groups of assets should not be a substitute for the recognition of impairment losses on individual assets.—~~

~~BC121 The Board decided that assets that are individually assessed for impairment and identified as impaired should be excluded from a portfolio assessment of impairment. Excluding assets that are individually identified as impaired from a portfolio assessment of impairment is consistent with the view that collective evaluation of impairment is an interim step pending the identification of impairment losses on individual assets. A collective evaluation identifies losses that have been incurred on a group basis as of the balance sheet date, but cannot yet be identified with individual assets. As soon as information is available to identify losses on individually impaired assets, those assets are removed from the group that is collectively assessed for impairment.—~~

Grouping of assets that are collectively evaluated for impairment (paragraphs 64 and AG87)—

~~BC122 The Board considered how assets that are collectively assessed for impairment should be grouped for the purpose of assessing impairment on a portfolio basis. In practice, different methods are conceivable for grouping assets for the purposes of assessing impairment and computing historical and expected loss rates. For example, assets may be~~

~~grouped on the basis of one or more of the following characteristics: (a) estimated default probabilities or credit risk grades; (b) type (for example, mortgage loans or credit card loans); (c) geographical location; (d) collateral type; (e) counterparty type (for example, consumer, commercial or sovereign); (f) past due status; and (g) maturity. More sophisticated credit risk models or methodologies for estimating expected future cash flows may combine several factors, for example, a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past due status, and other relevant characteristics of the assets being evaluated and associated loss data.~~

~~BC123 The Board decided that for the purpose of assessing impairment on a portfolio basis, the method employed for grouping assets should, as a minimum, ensure that individual assets are allocated to groups of assets that share similar credit risk characteristics. It also decided to clarify that when assets that are assessed individually and found not to be impaired are grouped with assets with similar credit risk characteristics that are assessed only on a collective basis, the loss probabilities and other loss statistics differ between the two types of asset with the result that a different amount of impairment may be required.~~

~~*Estimates of future cash flows in groups (paragraphs AG89-AG92)*~~

~~BC124 The Board decided that to promote consistency in the estimation of impairment on groups of financial assets that are collectively evaluated for impairment, guidance should be provided about the process for estimating future cash flows in such groups. It identified the following elements as critical to an adequate process:~~

- ~~(a) Historical loss experience should provide the basis for estimating future cash flows in a group of financial assets that are collectively assessed for impairment.~~
- ~~(b) Entities that have no loss experience of their own or insufficient experience should use peer group experience for comparable groups of financial assets.~~
- ~~(c) Historical loss experience should be adjusted, on the basis of observable data, to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.~~
- ~~(d) Changes in estimates of future cash flows should be directionally consistent with changes in underlying observable data.~~
- ~~(e) Estimation methods should be adjusted to reduce differences between estimates of future cash flows and actual cash flows.~~

~~*Impairment of investments in available for sale financial assets (paragraphs 67-70)*~~

~~BC125 In the Exposure Draft, the Board proposed that impairment losses on debt and equity instruments classified as available for sale should not be reversed through profit or loss if conditions changed after the recognition of the impairment loss. The Board arrived at this decision because of the difficulties in determining objectively when impairment losses on debt and equity instruments classified as available for sale have been recovered and hence of distinguishing a reversal of an impairment (recognised in profit or loss) from other increases in value (recognised in equity). Accordingly, the Board proposed that any increase in the fair value of an available for sale financial asset would be recognised directly in equity even though the entity had previously recognised an impairment loss on~~

that asset. The Board noted that this was consistent with the recognition of changes in the fair value of available for sale financial assets directly in equity* (see paragraph 55(b)).

BC126 The Board considered the comments received on its proposal to preclude reversals of impairment on available for sale financial assets. It concluded that available for sale debt instruments and available for sale equity instruments should be treated differently.

Reversals of impairment on available for sale debt instruments (paragraph 70)

BC127 For available for sale debt instruments, the Board decided that impairment should be reversed through profit or loss when fair value increases and the increase can be objectively related to an event occurring after the loss was recognised.

BC128 The Board noted that (a) other Standards require the reversal of impairment losses if circumstances change (eg IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*); (b) the decision provides consistency with the requirement to reverse impairment losses on loans and receivables, and on assets classified as held to maturity; and (c) reversals of impairment in debt instruments (ie determining an increase in fair value attributable to an improvement in credit standing) are more objectively determinable than those in equity instruments.

Reversals of impairment on available for sale equity instruments (paragraph 69)

BC129 For available for sale equity instruments, the Board concluded that if impairment is recognised, and the fair value subsequently increases, the increase in value should be recognised in equity (and not as a reversal of the impairment loss through profit or loss).

BC130 The Board could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value. Therefore, it decided that precluding reversals of impairment on available for sale equity instruments was the only appropriate solution. In its deliberations, the Board considered:

- (a) limiting reversals to those cases in which specific facts that caused the original impairment reverse. However, the Board questioned the operationality of applying this approach (ie how to decide whether the same event that caused the impairment caused the reversal).
- (b) recognising all changes in fair value below cost as impairments and reversals of impairment through profit or loss, ie all changes in fair value below cost would be recognised in profit or loss, and all changes above cost would be recognised in equity. Although this approach achieves consistency with IAS 16 and IAS 38, and eliminates any subjectivity involved in determining what constitutes impairment or reversal of impairment, the Board noted that it would significantly change the notion of 'available for sale' in practice. The Board believed that introducing such a change to the available for sale category was not appropriate at this time.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such changes are recognised in other comprehensive income.

Hedging

BC131 The Exposure Draft proposed few changes to the hedge accounting guidance in the original IAS 39. The comments on the Exposure Draft raised several issues in the area of hedge accounting suggesting that the Board should consider these issues in the revised IAS 39. The Board's decisions with regard to these issues are presented in the following paragraphs.

Consideration of the shortcut method in SFAS 133

BC132 SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* issued by the FASB allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method').

BC133 The original IAS 39 and the Exposure Draft precluded the use of the shortcut method. Many comments received on the Exposure Draft argued that IAS 39 should permit use of the shortcut method. The Board considered the issue in developing the Exposure Draft, and discussed it in the roundtable discussions that were held in the process of finalising IAS 39.

BC134 The Board noted that, if the shortcut method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the shortcut method.

BC135 Additionally, IAS 39 permits the hedging of portions of financial assets and financial liabilities in cases when US GAAP does not. The Board noted that under IAS 39 an entity may hedge a portion of a financial instrument (eg interest rate risk or credit risk), and that if the critical terms of the hedging instrument and the hedged item are the same, the entity would, in many cases, recognise no ineffectiveness.

Hedges of portions of financial assets and financial liabilities (paragraphs 81, 81A, AG99A and AG99B)

BC135A IAS 39 permits a hedged item to be designated as a portion of the cash flows or fair value of a financial asset or financial liability. In finalising the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, the Board received comments that demonstrated that the meaning of a 'portion' was unclear in this context. Accordingly, the Board decided to amend IAS 39 to provide further guidance on what may be designated as a hedged portion, including confirmation that it is not possible to designate a portion that is greater than the total cash flows of the asset or liability.

Expected effectiveness (paragraphs AG105–AG113)

BC136 Qualification for hedge accounting is based on expectations of future effectiveness (prospective) and evaluation of actual effectiveness (retrospective). In the original IAS 39, the prospective test was expressed as 'almost fully offset', whereas the retrospective test was 'within a range of 80-125 per cent'. The Board considered whether to amend IAS 39 to permit the prospective effectiveness to be within the range of 80-125 per cent rather than "almost fully offset". The Board noted that an undesirable consequence of such an amendment could be that entities would deliberately underhedge a hedged item in a cash

flow hedge so as to reduce recognised ineffectiveness. Therefore, the Board initially decided to retain the guidance in the original IAS 39.

BC136A However, when subsequently finalising the requirements for portfolio hedges of interest rate risk, the Board received representations from constituents that some hedges would fail the “almost fully offset” test in IAS 39, including some hedges that would qualify for the short-cut method in US GAAP and thus be assumed to be 100 per cent effective. The Board was persuaded that the concern described in the previous paragraph that an entity might deliberately underhedge would be met by an explicit statement that an entity could not deliberately hedge less than 100 per cent of the exposure on an item and designate the hedge as a hedge of 100 per cent of the exposure. Therefore, the Board decided to amend IAS 39:

- (a) to remove the words ‘almost fully offset’ from the prospective effectiveness test, and replace them by a requirement that the hedge is expected to be “highly effective”. (This amendment is consistent with the wording in US GAAP.)
- (b) to include a statement in the Application Guidance in IAS 39 that if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness on the basis of the change in the whole of that designated 85 per cent exposure.

BC136B Additionally, comments made in response to the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* demonstrated that it was unclear how the prospective effectiveness test was to be applied. The Board noted that the objective of the test was to ensure there was firm evidence to support an expectation of high effectiveness. Therefore, the Board decided to amend the Standard to clarify that an expectation of high effectiveness may be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value of cash flows of the hedged item and those of the hedging instrument. The Board noted that the entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

Hedges of portions of non-financial assets and non-financial liabilities for risk other than foreign currency risk (paragraph 82)

BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non-financial item other than foreign currency risk.

BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.

BC139 The Board confirmed that non-financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the

market. In this context, the Board decided to clarify that a hedge ratio of other than one-to-one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

Loan servicing rights

- BC140 The Board also considered whether IAS 39 should permit the interest rate risk portion of loan servicing rights to be designated as the hedged item.
- BC141 The Board considered the argument that interest rate risk can be separately identified and measured in loan servicing rights, and that changes in market interest rates have a predictable and separately measurable effect on the value of loan servicing rights. The Board also considered the possibility of treating loan servicing rights as financial assets (rather than non-financial assets).
- BC142 However, the Board concluded that no exceptions should be permitted for this matter. The Board noted that (a) the interest rate risk and prepayment risk in loan servicing rights are interdependent, and thus inseparable, (b) the fair values of loan servicing rights do not change in a linear fashion as interest rates increase or decrease, and (c) concerns exist about how to isolate and measure the interest rate risk portion of a loan servicing right. Moreover, the Board expressed concern that in jurisdictions in which loan servicing right markets are not developed, the interest rate risk portion may not be measurable.
- BC143 The Board also considered whether IAS 39 should be amended to allow, on an elective basis, the inclusion of loan servicing rights in its scope provided that they are measured at fair value with changes in fair value recognised immediately in profit or loss. The Board noted that this would create two exceptions to the general principles in IAS 39. First, it would create a scope exception because IAS 39 applies only to financial assets and financial liabilities; loan servicing rights are non-financial assets. Second, *requiring* an entity to measure loan servicing rights at fair value through profit or loss would create a further exception, because this treatment is optional (except for items that are held for trading). The Board therefore decided not to amend the scope of IAS 39 for loan servicing rights.

Whether to permit hedge accounting using cash instruments

- BC144 In finalising the amendments to IAS 39, the Board discussed whether an entity should be permitted to designate a financial asset or financial liability other than a derivative (ie a 'cash instrument') as a hedging instrument in hedges of risks other than foreign currency risk. The original IAS 39 precluded such designation because of the different bases for measuring derivatives and cash instruments. The Exposure Draft did not propose a change to this limitation. However, some commentators suggested a change, noting that entities do not distinguish between derivative and non-derivative financial instruments in their hedging and other risk management activities and that entities may have to use a non-derivative financial instrument to hedge risk if no suitable derivative financial instrument exists.
- BC145 The Board acknowledged that some entities use non-derivatives to manage risk. However, it decided to retain the restriction against designating non-derivatives as hedging instruments in hedges of risks other than foreign currency risk. It noted the following arguments in support of this conclusion:
- (a) The need for hedge accounting arises in part because derivatives are measured at fair value, whereas the items they hedge may be measured at cost or not

recognised at all. Without hedge accounting, an entity might recognise volatility in profit or loss for matched positions. For non-derivative items that are not measured at fair value or for which changes in fair value are not recognised in profit or loss, there is generally no need to adjust the accounting of the hedging instrument or the hedged item to achieve matched recognition of gains and losses in profit or loss.

- (b) To allow designation of cash instruments as hedging instruments would diverge from US GAAP: SFAS 133 precludes the designation of non-derivative instruments as hedging instruments except for some foreign currency hedges.
- (c) To allow designation of cash instruments as hedging instruments would add complexity to the Standard. More financial instruments would be measured at an amount that represents neither amortised cost nor fair value. Hedge accounting is, and should be, an exception to the normal measurement requirements.
- (d) If cash instruments were permitted to be designated as hedging instruments, there would be much less discipline in the accounting model because, in the absence of hedge accounting, a non-derivative may not be selectively measured at fair value. If the entity subsequently decides that it would rather not apply fair value measurement to a cash instrument that had been designated as a hedging instrument, it can breach one of the hedge accounting requirements, conclude that the non-derivative no longer qualifies as a hedging instrument and selectively avoid recognising the changes in fair value of the non-derivative instrument in equity (for a cash flow hedge) or profit or loss (for a fair value hedge).
- (e) The most significant use of cash instruments as hedging instruments is to hedge foreign currency exposures, which is permitted under IAS 39.

Whether to treat hedges of forecast transactions as fair value hedges

BC146 The Board considered a suggestion made in some of the comment letters received on the Exposure Draft that a hedge of a forecast transaction should be treated as a fair value hedge, rather than as a cash flow hedge. Some argued that the hedge accounting provisions should be simplified by having only one type of hedge accounting. Some also raised concern about an entity's ability, in some cases, to choose between two hedge accounting methods for the same hedging strategy (ie the choice between designating a forward contract to sell an existing asset as a fair value hedge of the asset or a cash flow hedge of a forecast sale of the asset).

BC147 The Board acknowledged that the hedge accounting provisions would be simplified, and their application more consistent in some situations, if the Standard permitted only one type of hedge accounting. However, the Board concluded that IAS 39 should continue to distinguish between fair value hedge accounting and cash flow hedge accounting. It noted that removing either type of hedge accounting would narrow the range of hedging strategies that could qualify for hedge accounting.

BC148 The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the *Framework*; and (c) transactions in which there is no fair value exposure would be

treated as if there were a fair value exposure.

Hedges of firm commitments (paragraphs 93 and 94)

- BC149 The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. In other words, hedging gains and losses, to the extent that the hedge is effective, were initially recognised in equity and were subsequently ‘recycled’ to profit or loss in the same period(s) that the hedged firm commitment affected profit or loss (although, when basis adjustment was used, they adjusted the initial carrying amount of an asset or liability recognised in the meantime). Some believe this is appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised. Moreover, some believe it is conceptually incorrect to recognise the hedged fair value exposure of a firm commitment as an asset or liability merely because it has been hedged.
- BC150 The Board considered whether hedges of firm commitments should be treated as cash flow hedges or fair value hedges. The Board concluded that hedges of firm commitments should be accounted for as fair value hedges.
- BC151 The Board noted that, in concept, a hedge of a firm commitment is a fair value hedge. This is because the fair value of the item being hedged (the firm commitment) changes with changes in the hedged risk.
- BC152 The Board was not persuaded by the argument that it is conceptually incorrect to recognise an asset or liability for a firm commitment merely because it has been hedged. It noted that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised. For example, assume an entity hedges a fixed rate loan asset with a pay-fixed, receive-variable interest rate swap. If there is a loss on the swap, applying fair value hedge accounting requires the offsetting gain on the loan to be recognised, ie the carrying amount of the loan is increased. Thus, applying hedge accounting has the effect of recognising a part of an asset (the increase in the loan’s value attributable to interest rate movements) that would otherwise not have been recognised. The only difference in the case of a firm commitment is that, without hedge accounting, none of the commitment is recognised, ie the carrying amount is zero. However, this difference merely reflects that the historical cost of a firm commitment is usually zero. It is not a fundamental difference in concept.
- BC153 Furthermore, the Board’s decision converges with SFAS 133, and thus eliminates practical problems and eases implementation for entities that report under both standards.
- BC154 However, the Board clarified that a hedge of the foreign currency risk of a firm commitment may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly a foreign currency cash flow hedge of a forecast transaction need not be re-designated as a fair value hedge when the forecast transaction becomes a firm commitment.

Basis adjustments (paragraphs 97-99)

- BC155 The question of basis adjustment arises when an entity hedges the future purchase of an asset or the future issue of a liability. One example is that of a US entity that expects to make a future purchase of a German machine that it will pay for in euro. The entity enters into a derivative to hedge against possible future changes in the US dollar / euro

exchange rate. Such a hedge is classified as a cash flow hedge under IAS 39, with the effect that gains and losses on the hedging instrument (to the extent that the hedge is effective) are initially recognised in equity.* The question the Board considered is what the accounting should be once the future transaction takes place. In its deliberations on this issue, the Board discussed the following approaches:

- (a) to remove the hedging gain or loss from equity and recognise it as part of the initial carrying amount of the asset or liability (in the example above, the machine). In future periods, the hedging gain or loss is automatically recognised in profit or loss by being included in amounts such as depreciation expense (for a fixed asset), interest income or expense (for a financial asset or financial liability), or cost of sales (for inventories). This treatment is commonly referred to as ‘basis adjustment’.
- (b) to leave the hedging gain or loss in equity. In future periods, the gain or loss on the hedging instrument is ‘recycled’ to profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. This recycling requires a separate adjustment and is not automatic.

BC156 It should be noted that both approaches have the same effect on profit or loss and net assets for all periods affected, so long as the hedge is accounted for as a cash flow hedge. The difference relates to balance sheet presentation and, possibly, the line item in the income statement.

BC157 In the Exposure Draft, the Board proposed that the ‘basis adjustment’ approach for forecast transactions (approach (a)) should be eliminated and replaced by approach (b) above. It further noted that eliminating the basis adjustment approach would enable IAS 39 to converge with SFAS 133.

BC158 Many of the comments received from constituents disagreed with the proposal in the Exposure Draft. Those responses argued that it would unnecessarily complicate the accounting to leave the hedging gain or loss in equity when the hedged forecast transaction occurs. They particularly noted that tracking the effects of cash flow hedges after the asset or liability is acquired would be complicated and would require systems changes. They also pointed out that treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment results in the recognition of an asset or liability. For example, for a perfectly effective hedge of the foreign currency risk of a firm commitment to buy a machine, the effect is to recognise the machine initially at its foreign currency price translated at the forward rate in effect at the inception of the hedge rather than the spot rate. Therefore, they questioned whether it is consistent to treat a hedge of a firm commitment as a fair value hedge while precluding basis adjustments for hedges of forecast transactions.

BC159 Others believe that a basis adjustment is difficult to justify in principle for forecast transactions, and also argue that such basis adjustments impair comparability of financial information. In other words, two identical assets that are purchased at the same time and in the same way, except for the fact that one was hedged, should not be recognised at different amounts.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

BC160 The Board concluded that IAS 39 should distinguish between hedges of forecast transactions that will result in the recognition of a *financial* asset or a *financial* liability and those that will result in the recognition of a *non-financial* asset or a *non-financial* liability.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability

BC161 For hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability, the Board concluded that basis adjustments are not appropriate. Its reason was that basis adjustments cause the initial carrying amount of acquired assets (or assumed liabilities) arising from forecast transactions to move away from fair value and hence would override the requirement in IAS 39 to measure a financial instrument initially at its fair value.

BC161A If a hedged forecast transaction results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 required the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged item affects profit or loss (such as in the periods that interest income or interest expense is recognised).

BC161B The Board was informed that there was uncertainty about how paragraph 97 should be applied when the designated cash flow exposure being hedged differs from the financial instrument arising from the hedged forecast cash flows.

BC161C The example below illustrates the issue:

An entity applies the guidance in the answer to Question F.6.2 of the guidance on implementing IAS 39.^(a) On 1 January 20X0 the entity designates forecast cash flows for the risk of variability arising from changes in interest rates. Those forecast cash flows arise from the repricing of existing financial instruments and are scheduled for 1 April 20X0. The entity is exposed to variability in cash flows for the three-month period beginning on 1 April 20X0 attributable to changes in interest rate risk that occur from 1 January 20X0 to 31 March 20X0.

The occurrence of the forecast cash flows is deemed to be highly probable and all the other relevant hedge accounting criteria are met.

The financial instrument that results from the hedged forecast cash flows is a five-year interest-bearing instrument.

(a) IFRS 9 *Financial Instruments* deletes the guidance in IAS 39.

BC161D Paragraph 97 required the gains or losses on the hedging instrument to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affected profit or loss. The financial instrument that was recognised is a five-year instrument that will affect profit or loss for five years. The wording in paragraph 97 suggested that the gains or losses should be reclassified over five years, even though the cash flows designated as the hedged item were hedged for the effects of interest rate changes over only a three-month period.

BC161E The Board believes that the wording of paragraph 97 did not reflect the underlying rationale in hedge accounting, ie that the gains or losses on the hedging instrument should offset the gains or losses on the hedged item, and the offset should be reflected in profit or loss by way of reclassification adjustments.

BC161F The Board believes that in the example set out above the gains or losses should be reclassified over a period of three months beginning on 1 April 20X0, and not over a period of five years beginning on 1 April 20X0.

BC161G Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 97 of IAS 39 to clarify that the gains or losses on the hedged instrument should be reclassified from equity to profit or loss during the period that the hedged forecast cash flows affect profit or loss. The Board also decided that to avoid similar confusion paragraph 100 of IAS 39 should be amended to be consistent with paragraph 97.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

BC162 For hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability, the Board decided to permit entities a choice of whether to apply basis adjustment.

BC163 The Board considered the argument that changes in the fair value of the hedging instrument are appropriately included in the initial carrying amount of the recognised asset or liability because such changes represent a part of the 'cost' of that asset or liability. Although the Board has not yet considered the broader issue of what costs may be capitalised at initial recognition, the Board believes that its decision to provide an option for basis adjustments in the case of non-financial items will not pre-empt that future discussion. The Board also recognised that financial items and non-financial items are not necessarily measured at the same amount on initial recognition, because financial items are measured at fair value and non-financial items are measured at cost.

BC164 The Board concluded that, on balance, providing entities with a choice in this case was appropriate. The Board took the view that allowing basis adjustments addresses the concern that precluding basis adjustments complicates the accounting for hedges of forecast transactions. In addition, the number of balance sheet line items that could be affected is quite small, generally being only property, plant and equipment, inventory and the cash flow hedge line item in equity. The Board also noted that US GAAP precludes basis adjustments and that applying a basis adjustment is inconsistent with the accounting for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability. The Board acknowledged the merits of these arguments, and recognised that by permitting a choice in IAS 39, entities could apply the accounting treatment required by US GAAP.

Hedging using internal contracts

BC165 IAS 39 does not preclude entities from using internal contracts as a risk management tool, or as a tracking device in applying hedge accounting for external contracts that hedge external positions. Furthermore, IAS 39 permits hedge accounting to be applied to transactions between entities in the same group in the *separate reporting* of those entities. However, IAS 39 does not permit hedge accounting for transactions between entities in the same group in consolidated financial statements. The reason is the fundamental requirement of consolidation that the accounting effects of internal contracts should be eliminated in consolidated financial statements, including any internally generated gains or losses. Designating internal contracts as hedging instruments could result in non-elimination of internal gains and losses and have other accounting effects. The Exposure Draft did not propose any change in this area.

- BC166 To illustrate, assume the banking book division of Bank A enters into an internal interest rate swap with the trading book division of the same bank. The purpose is to hedge the net interest rate risk exposure in the banking book of a group of similar fixed rate loan assets funded by floating rate liabilities. Under the swap, the banking book pays fixed interest payments to the trading book and receives variable interest rate payments in return. The bank wants to designate the internal interest rate swap in the banking book as a hedging instrument in its consolidated financial statements.
- BC167 If the internal swap in the banking book is designated as a hedging instrument in a cash flow hedge of the liabilities, and the internal swap in the trading book is classified as held for trading, internal gains and losses on that internal swap would not be eliminated. This is because the gains and losses on the internal swap in the banking book would be recognised in equity* to the extent the hedge is effective and the gains and losses on the internal swap in the trading book would be recognised in profit or loss.
- BC168 If the internal swap in the banking book is designated as a hedging instrument in a fair value hedge of the loan assets and the internal swap in the trading book is classified as held for trading, the changes in the fair value of the internal swap would offset both in total net assets in the balance sheet and profit or loss. However, without elimination of the internal swap, there would be an adjustment to the carrying amount of the hedged loan asset in the banking book to reflect the change in the fair value attributable to the risk hedged by the internal contract. Moreover, to reflect the effect of the internal swap the bank would in effect recognise the fixed rate loan at a floating interest rate and recognise an offsetting trading gain or loss in the income statement. Hence the internal swap would have accounting effects.
- BC169 Some respondents to the Exposure Draft and some participants in the round-tables objected to not being able to obtain hedge accounting in the consolidated financial statements for internal contracts between subsidiaries or between a subsidiary and the parent (as illustrated above). Among other things, they emphasised that the use of internal contracts is a key risk management tool and that the accounting should reflect the way in which risk is managed. Some suggested that IAS 39 should be changed to make it consistent with US GAAP, which allows the designation of internal derivative contracts as hedging instruments in cash flow hedges of forecast foreign currency transactions in specified, limited circumstances.
- BC170 In considering these comments, the Board noted that the following principles apply to consolidated financial statements:
- (a) financial statements provide financial information about an entity or group as a whole (as that of a single entity). Financial statements do not provide financial information about an entity as if it were two separate entities.
 - (b) a fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts as hedging instruments would require a change to the consolidation principles.
 - (c) it is conceptually wrong to permit an entity to recognise internally generated gains and losses or make other accounting adjustments because of internal transactions. No external event has occurred.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

- (d) an ability to recognise internally generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control the associated risks. It is not the purpose of accounting standards to prescribe how entities should manage and control risks.
- (e) permitting the designation of internal contracts as hedging instruments violates the following requirements in IAS 39:
 - (i) the prohibition against designating as a hedging instrument a non-derivative financial asset or non-derivative financial liability for other than foreign currency risk. To illustrate, if an entity has two offsetting internal contracts and one is the designated hedging instrument in a fair value hedge of a non-derivative asset and the other is the designated hedging instrument in a fair value hedge of a non-derivative liability, from the entity's perspective the effect is to designate a hedging relationship between the asset and the liability (ie a non-derivative asset or non-derivative liability is used as the hedging instrument).
 - (ii) the prohibition on designating a net position of assets and liabilities as the hedged item. To illustrate, an entity has two internal contracts. One is designated in a fair value hedge of an asset and the other in a fair value hedge of a liability. The two internal contracts do not fully offset, so the entity lays off the net risk exposure by entering into a net external derivative. In that case, the effect from the entity's perspective is to designate a hedging relationship between the net external derivative and a net position of an asset and a liability.
 - (iii) the option to fair value assets and liabilities does not extend to portions of assets and liabilities.
- (f) the Board is considering separately whether to make an amendment to IAS 39 to facilitate fair value hedge accounting for portfolio hedges of interest rate risk. The Board believes that that is a better way to address the concerns raised about symmetry with risk management systems than permitting the designation of internal contracts as hedging instruments.
- (g) the Board decided to permit an option to measure any financial asset or financial liability at fair value with changes in fair value recognised in profit or loss. This enables an entity to measure matching asset/liability positions at fair value without a need for hedge accounting.

BC171 The Board reaffirmed that it is a fundamental principle of consolidation that any accounting effect of internal contracts is eliminated on consolidation. The Board decided that no exception to this principle should be made in IAS 39. Consistently with this decision, the Board also decided not to explore an amendment to permit internal derivative contracts to be designated as hedging instruments in hedges of some forecast foreign currency transactions, as is permitted by SFAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities*.

BC172 The Board also decided to clarify that IAS 39 does not preclude hedge accounting for transactions between entities in the same group in individual or separate financial statements of those entities because they are not internal to the entity (ie the individual entity).

BC172A Previously, paragraphs 73 and 80 referred to the need for hedging instruments to involve a party external to the reporting entity. In doing so, ~~it~~ they used a segment as an example of a reporting entity. However, IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non-IFRS basis. Therefore, the two IFRSs appeared to conflict. In *Improvements to IFRSs* issued in May 2008 and April 2009, the Board removed from paragraphs 73 and 80 references to the designation of hedging instruments at the segment level.

Eligible hedged items in particular situations (paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B)

BC172B The Board amended IAS 39 in July 2008 to clarify the application of the principles that determine whether a hedged risk or portion of cash flows is eligible for designation in particular situations. This followed a request by the IFRIC for guidance.

BC172C The responses to the exposure draft *Exposures Qualifying for Hedge Accounting* demonstrated that diversity in practice existed, or was likely to occur, in two situations:

- (a) the designation of a one-sided risk in a hedged item
- (b) the designation of inflation as a hedged risk or portion in particular situations.

Designation of a one-sided risk in a hedged item

BC172D The IFRIC received requests for guidance on whether an entity can designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option, including changes in the time value, are regarded as effective and would be recognised in other comprehensive income. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172E After considering the responses to the exposure draft, the Board confirmed that the designation set out in paragraph BC172D is not permitted.

BC172F The Board reached that decision by considering the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase (a one-sided risk). The Board noted that the forecast transaction contained no separately identifiable risk that affects profit or loss that is equivalent to the time value of a purchased option hedging instrument (with the same principal terms as the designated risk). The Board concluded that the intrinsic value of a purchased option, but not its time value, reflects a one-sided risk in a hedged item. The Board then considered a purchased option designated in its entirety as the hedging instrument. The Board noted that hedge accounting is based on a principle of offsetting changes in fair value or cash flows between the hedging instrument and the hedged item. Because a designated one-sided risk does not contain the time value of a purchased option hedging instrument, the Board noted that there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. Therefore, the Board concluded that a purchased option designated in its entirety as the hedging instrument of a one-sided risk will not be perfectly effective.

Designation of inflation in particular situations

BC172G The IFRIC received a request for guidance on whether, for a hedge of a fixed rate financial instrument, an entity can designate inflation as the hedged item. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172H After considering the responses to the exposure draft, the Board acknowledged that expectations of future inflation rates can be viewed as an economic component of nominal interest. However, the Board also noted that hedge accounting is an exception to normal accounting principles for the hedged item (fair value hedges) or hedging instrument (cash flow hedges). To ensure a disciplined use of hedge accounting the Board noted that restrictions regarding eligible hedged items are necessary, especially if something other than the entire fair value or cash flow variability of a hedged item is designated.

BC172I The Board noted that paragraph 81 permits an entity to designate as the hedged item something other than the entire fair value change or cash flow variability of a financial instrument. For example, an entity may designate some (but not all) risks of a financial instrument, or some (but not all) cash flows of a financial instrument (a 'portion').

BC172J The Board noted that, to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the fair value or cash flows of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. The Board noted that these principles were important in order for the effectiveness requirements set out in paragraph 88 to be applied in a meaningful way. The Board also noted that deciding whether designated risks and portions are separately identifiable and reliably measurable requires judgement. However, the Board confirmed that unless the inflation portion is a contractually specified portion of cash flows and other cash flows of the financial instrument are not affected by the inflation portion, inflation is not separately identifiable and reliably measurable and is not eligible for designation as a hedged risk or portion of a financial instrument.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Background

BC173 The Exposure Draft of proposed improvements to IAS 39 published in June 2002 did not propose any substantial changes to the requirements for hedge accounting as they applied to a portfolio hedge of interest rate risk. However, some of the comment letters on the Exposure Draft and participants in the round-table discussions raised this issue. In particular, some were concerned that portfolio hedging strategies they regarded as effective hedges would not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39. Rather, they would have either:

- (a) not qualified for hedge accounting at all, with the result that reported profit or loss would be volatile; or
- (b) qualified only for cash flow hedge accounting, with the result that reported equity would be volatile.

BC174 In the light of these concerns, the Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges of interest rate risk. As a result, in August 2003 the Board published a second Exposure Draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003. More than 120 comment letters were received. The amendments proposed in this second Exposure Draft were finalised in March 2004. Paragraphs BC135A-BC136B and BC175-BC220 summarise the Board's considerations in reaching conclusions on the issues raised.

Scope

BC175 The Board decided to limit any amendments to IAS 39 to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:

- (a) implementation guidance on IAS 39* explains how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.
- (b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in paragraph BC176 do not arise in combination for such other hedging arrangements.

The issue: why fair value hedge accounting was difficult to achieve in accordance with previous versions of IAS 39

BC176 The Board identified the following three main reasons why a portfolio hedge of interest rate risk might not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39.

- (a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual repricing date. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness tests.[#] Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement[?] that a group of hedged assets or liabilities must be 'similar' and the related requirement⁺ that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.
- (b) IAS 39[◆] prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets or a group of similar assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.

* IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39, see Q&A F.6.1 and F.6.2

see IAS 39, paragraph AG105

? see IAS 39, paragraph 78

+ see IAS 39, paragraph 83

◆ see IAS 39, paragraph AG101

- (c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk. ^{**} Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life. [†] This, too, gives rise to significant systems needs.

BC177 The Board decided that any change to IAS 39 must be consistent with the principles that underlie IAS 39's requirements on derivatives and hedge accounting. The three principles that are most relevant to a portfolio hedge of interest rate risk are:

- (a) derivatives should be measured at fair value;
- (b) hedge ineffectiveness should be identified and recognised in profit or loss;^{*} and
- (c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet.

Prepayment risk

BC178 In considering the issue described in paragraph BC176(a), the Board noted that a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. It follows that the fair value of a fixed rate prepayable item changes for two reasons when interest rates move:

- (a) the fair value of the contracted cash flows to the contractual repricing date changes (because the rate used to discount them changes); and
- (b) the fair value of the prepayment option changes (reflecting, among other things, that the likelihood of prepayment is affected by interest rates).

BC179 The Board also noted that, for risk management purposes, many entities do not consider these two effects separately. Instead they incorporate the effect of prepayments by grouping the hedged portfolio into repricing time periods based on *expected* repayment dates (rather than contractual repayment dates). For example, an entity with a portfolio of 25-year mortgages of CU100 may expect 5 per cent of that portfolio to repay in one year's time, in which case it schedules an amount of CU5 into a 12-month time period. The entity schedules all other items contained in its portfolio in a similar way (ie on the basis of expected repayment dates) and hedges all or part of the resulting overall net position in each repricing time period.

BC180 The Board decided to permit the scheduling that is used for risk management purposes, ie on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting. As a result, an entity would not be required to compute the effect that a change in interest rates has on the fair value of the prepayment option embedded in a prepayable item. Instead, it could incorporate the effect of a change in interest rates on prepayments by grouping the hedged portfolio into repricing time periods based on expected repayment dates. The Board noted that this approach has significant practical advantages for preparers of financial statements, because it allows

^{**} see IAS 39, paragraph 89(b)

[†] see IAS 39, paragraph 92

^{*} Subject to the same materiality considerations that apply in this context as throughout IFRSs.

them to use the data they use for risk management. The Board also noted that the approach is consistent with paragraph 81 of IAS 39, which permits hedge accounting for a portion of a financial asset or financial liability. However, as discussed further in paragraphs BC193-BC206, the Board also concluded that if the entity changes its estimates of the time periods in which items are expected to repay (eg in the light of recent prepayment experience), ineffectiveness will arise, regardless of whether the revision in estimates results in more or less being scheduled in a particular time period.

BC181 The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged.

Designation of the hedged item and liabilities with a demand feature

BC182 The Board considered two main ways to overcome the issue noted in paragraph BC176(b). These were:

- (a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a repricing time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.
- (b) to designate the hedged item as a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.

BC183 Some of those who commented on the Exposure Draft favoured designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset-liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.

BC184 In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

BC185 The Board noted that under the first approach in paragraph BC182 (designating an overall net position), an issue arises if the entity has liabilities that are repayable on demand or after a notice period (referred to below as 'demandable liabilities'). This includes items such as demand deposits and some types of time deposits. The Board was

informed that, when managing interest rate risk, many entities that have demandable liabilities include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of demandable liabilities in the portfolio to be due because of net withdrawals from the accounts in the portfolio. This expected repayment date is typically a period covering several years into the future (eg 0-10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include demandable liabilities in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

- (a) it is consistent with how demandable liabilities are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. The interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.
- (b) it is consistent with the treatment of prepayable assets to include demandable liabilities in a portfolio hedge based on expected repayment dates.
- (c) as with prepayable assets, expected maturities for demandable liabilities are based on the historical behaviour of customers.
- (d) applying the fair value hedge accounting framework to a portfolio that includes demandable liabilities would not entail an immediate gain on origination of such liabilities because all assets and liabilities enter the hedged portfolio at their carrying amounts. Furthermore, IAS 39^{*} requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (ie the amount deposited).^{*}
- (e) historical analysis shows that a base level of a portfolio of demandable liabilities, such as chequing accounts, is very stable. Whilst a portion of the demandable liabilities varies with interest rates, the remaining portion—the base level—does not. Hence, entities regard this base level as a long-term fixed rate item and include it as such in the scheduling that is used for risk management purposes.
- (f) the distinction between ‘old’ and ‘new’ money makes little sense at a portfolio level. The portfolio behaves like a long-term item even if individual liabilities do not.

BC186 The Board noted that this issue is related to that of how to measure the fair value of a demandable liability. In particular, it interrelates with the requirement in IAS 39⁺ that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.[±] This requirement applies to all liabilities with a demand feature, not only to those included in a portfolio hedge.

^{*}—see IAS 39, paragraph AG76

^{*} IFRS 9 *Financial Instruments* replaced IAS 39.

⁺—see IAS 39, paragraph 49

[±] IFRS 9 *Financial Instruments* replaced IAS 39.

BC187 The Board also noted that:

- (a) although entities, when managing risk, may schedule demandable liabilities based on the expected repayment date of the total balance of a portfolio of accounts, the deposit liabilities included in that balance are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Put another way, the balance of the portfolio is relatively stable only because withdrawals on some accounts (which usually occur relatively quickly) are offset by new deposits into others. Thus, the liability being hedged is actually the forecast replacement of existing deposits by the receipt of new deposits. IAS 39 does not permit a hedge of such a forecast transaction to qualify for fair value hedge accounting. Rather, fair value hedge accounting can be applied only to the liability (or asset) or firm commitment that exists today.
- (b) a portfolio of demandable liabilities is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit demandable liabilities to be included in a fair value hedge on the basis of a stable base level created by expected replacements, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.
- (c) a portfolio of similar core deposits is not different from an individual deposit, other than that, in the light of the ‘law of large numbers’, the behaviour of the portfolio is more predictable. There are no diversification effects from aggregating many similar items.
- (d) it would be inconsistent with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, to schedule such liabilities for hedging purposes using a different date. For example, consider a deposit of CU100 that can be withdrawn on demand without penalty. IAS 39 states that the fair value of such a deposit is CU100. That fair value is unaffected by interest rates and does not change when interest rates move. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk—there is no fair value exposure to hedge.

BC188 For these reasons, the Board concluded that demandable liabilities should not be included in a portfolio hedge on the basis of the expected repayment date of the *total balance of a portfolio* of demandable liabilities, ie including expected rollovers or replacements of existing deposits by new ones. However, as part of its consideration of comments received on the Exposure Draft, the Board also considered whether a demandable liability, such as a demand deposit, could be included in a portfolio hedge based on the expected repayment date of the *existing balance of individual deposits*, ie ignoring any rollovers or replacements of existing deposits by new deposits. The Board noted the following.

- (a) For many demandable liabilities, this approach would imply a much earlier expected repayment date than is generally assumed for risk management purposes. In particular, for chequing accounts it would probably imply an expected maturity of a few months or less. However, for other demandable liabilities, such as fixed term deposits that can be withdrawn only by the depositor incurring a significant penalty, it might imply an expected repayment

date that is closer to that assumed for risk management.

- (b) This approach implies that the *fair value* of the demandable liability should also reflect the expected repayment date of the existing balance, ie that the fair value of a demandable deposit liability is the present value of the amount of the deposit discounted from the expected repayment date. The Board noted that it would be inconsistent to permit fair value hedge accounting to be based on the expected repayment date, but to measure the fair value of the liability on initial recognition on a different basis. The Board also noted that this approach would give rise to a difference on initial recognition between the amount deposited and the fair value recognised in the balance sheet. This, in turn, gives rise to the issue of what the difference represents. Possibilities the Board considered include (i) the value of the depositor's option to withdraw its money before the expected maturity, (ii) prepaid servicing costs or (iii) a gain. The Board did not reach a conclusion on what the difference represents, but agreed that if it were to require such differences to be recognised, this would apply to all demandable liabilities, not only to those included in a portfolio hedge. Such a requirement would represent a significant change from present practice.
- (c) If the fair value of a demandable deposit liability at the date of initial recognition is deemed to equal the amount deposited, a fair value portfolio hedge based on an expected repayment date is unlikely to be effective. This is because such deposits typically pay interest at a rate that is significantly lower than that being hedged (eg the deposits may pay interest at zero or at very low rates, whereas the interest rate being hedged may be LIBOR or a similar benchmark rate). Hence, the fair value of the deposit will be significantly less sensitive to interest rate changes than that of the hedging instrument.
- (d) The question of how to fair value a demandable liability is closely related to issues being debated by the Board in other projects, including Insurance (phase II), Revenue Recognition, Leases and Measurement. The Board's discussions in these other projects are continuing and it would be premature to reach a conclusion in the context of portfolio hedging without considering the implications for these other projects.

BC189 As a result, the Board decided:

- (a) to confirm the requirement in IAS 39^a that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid',^{*} and
- (b) consequently, that a demandable liability cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

The Board noted that, depending on the outcome of its discussions in other projects (principally Insurance (phase II), Revenue Recognition, Leases and Measurement), it might reconsider these decisions at some time in the future.

^a — see IAS 39, paragraph 49

^{*} IFRS 9 *Financial Instruments* replaced IAS 39.

BC190 The Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a portion *of the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular repricing time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes to hedge its net exposure of CU20. Also assume that all of the liabilities are demandable liabilities and the time period is later than that containing the earliest date on which the items can be repaid. If the hedged item is designated as CU20 of *assets*, then the demandable *liabilities* are not included in the hedged item, but rather are used only to determine how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demandable liabilities can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item, because the net position comprises CU100 of assets and CU80 of demandable liabilities, whether the demandable liabilities can be designated as a hedged item in a fair value hedge becomes critical.

BC191 Given the above points, the Board decided that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the demandable liabilities issue. It also noted that this approach is consistent with IAS 39^{**}, whereas designating an overall net position is not. IAS 39[†] prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating an amount of assets (or liabilities) equal to the net position.

BC192 However, the Board also recognised that this method of designation would not fully resolve the demandable liabilities issue. In particular, the issue is still relevant if, in a particular repricing time period, the entity has so many demandable liabilities whose earliest repayment date is before that time period that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including the demandable liabilities) exceed its fixed rate assets in this repricing time period. In this case, the entity is in a net liability position. Thus, it needs to designate an amount of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than those that can be demanded before that time period, this implies designating the demandable liabilities as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting. (If the liabilities are non-interest bearing, they cannot be designated as the hedged item in a cash flow hedge because their cash flows do not vary with changes in interest rates, ie there is no cash flow exposure to interest rates.[‡] However, the hedging relationship may qualify for cash flow hedge accounting if designated as a hedge of associated assets.)

What portion of assets should be designated and the impact on ineffectiveness

BC193 Having decided that a portion of assets (or liabilities) could be designated as the hedged item, the Board considered how to overcome the systems problems noted in paragraph BC176(b) and (c). The Board noted that these problems arise from designating individual assets (or liabilities) as the hedged item. Accordingly, the Board decided that the hedged item could be expressed as an *amount* (of assets or liabilities) rather than as individual assets or liabilities.

^{**} see IAS 39, paragraph 84

[†] see IAS 39, paragraph AG101

[‡] see Guidance on Implementing IAS 39, Question and Answer F.6.3.

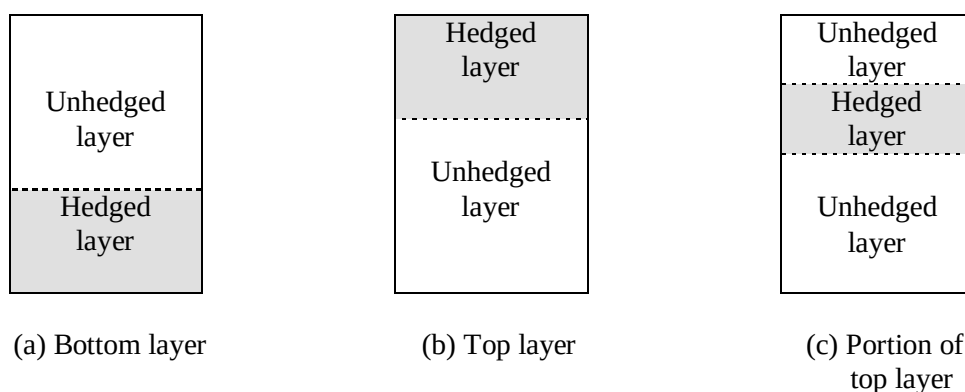
BC194 The Board noted that this decision—that the hedged item may be designated as an amount of assets or liabilities rather than as specified items—gives rise to the issue of how the amount designated should be specified. The Board considered comments received on the Exposure Draft that it should not specify any method for designating the hedged item and hence measuring effectiveness. However, the Board concluded that if it provided no guidance, entities might designate in different ways, resulting in little comparability between them. The Board also noted that its objective, when permitting an amount to be designated, was to overcome the systems problems associated with designating individual items whilst achieving a very similar accounting result. Accordingly, it concluded that it should require a method of designation that closely approximates the accounting result that would be achieved by designating individual items.

BC195 Additionally, the Board noted that designation determines how much, if any, ineffectiveness arises if actual repricing dates in a particular repricing time period vary from those estimated or if the estimated repricing dates are revised. Taking the above example of a repricing time period in which there are CU100 of fixed rate assets and the entity designates as the hedged item an amount of CU20 of assets, the Board considered two approaches (a layer approach and a percentage approach) that are summarised below.

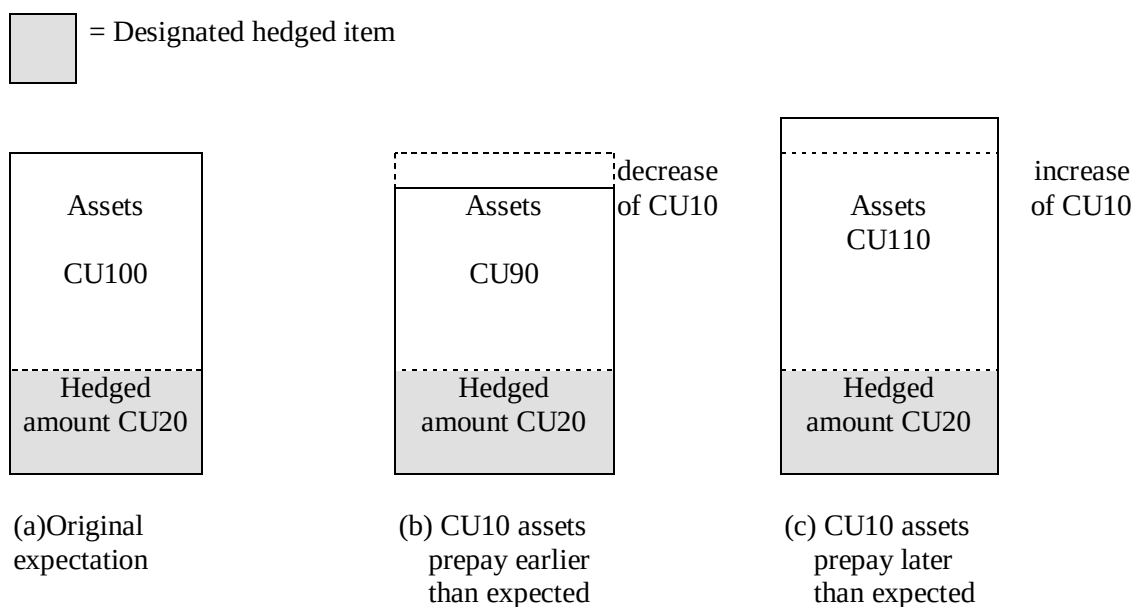
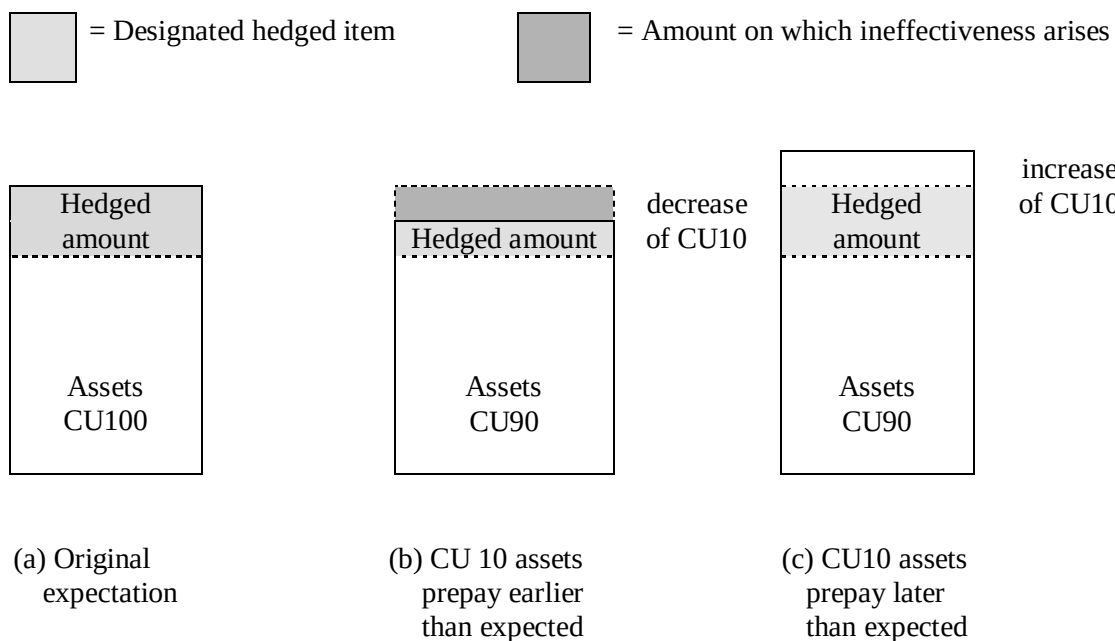
Layer approach

BC196 The first of these approaches, illustrated in figure 1, designates the hedged item as a ‘layer’ (eg (a) the bottom layer, (b) the top layer or (c) a portion of the top layer) of the assets (or liabilities) in a repricing time period. In this approach, the portfolio of CU100 in the above example is considered to comprise a hedged layer of CU20 and an unhedged layer of CU80.

Figure 1: Illustrating the designation of an amount of assets as a layer



BC197 The Board noted that the layer approach does not result in the recognition of ineffectiveness in all cases when the estimated amount of assets (or liabilities) changes. For example, in a bottom layer approach (see figure 2), if some assets prepay earlier than expected so that the entity revises downward its estimate of the amount of assets in the repricing time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged top layer (figure 2(b)). Whether any ineffectiveness arises depends on whether the downward revision reaches the hedged layer of CU20. Thus, if the bottom layer is designated as the hedged item, it is unlikely that the hedged (bottom) layer will be reached and that any ineffectiveness will arise. Conversely, if the top layer is designated (see figure 3), any downward revision to the estimated amount in a repricing time period will reduce the hedged (top) layer and ineffectiveness will arise (figure 3(b)).

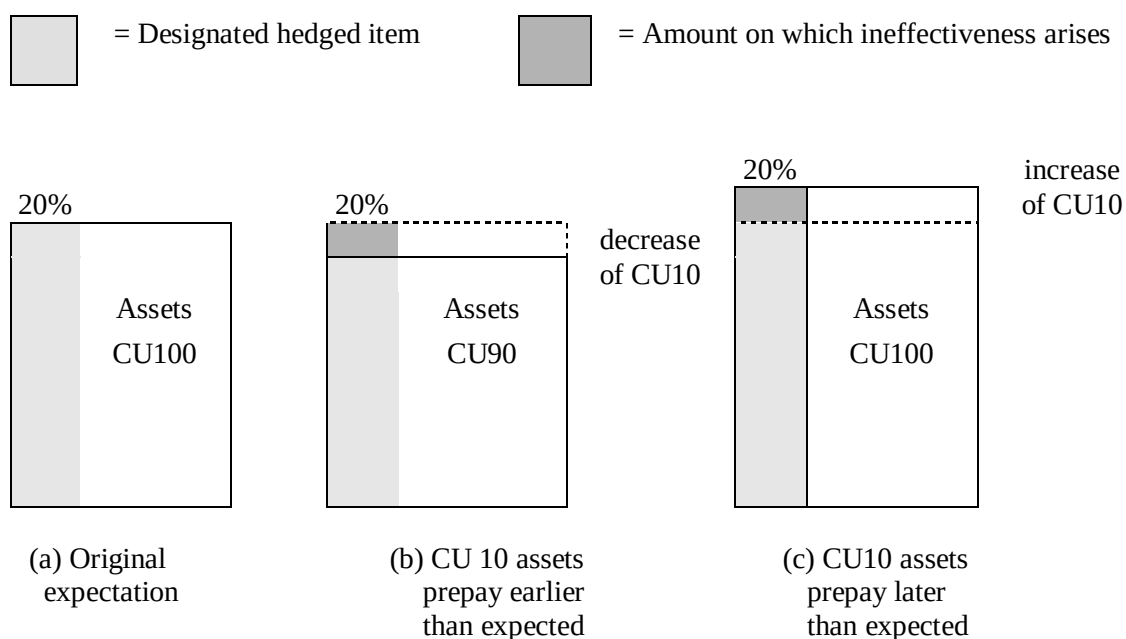
Figure 2: Illustrating the effect on changes in prepayments in a bottom layer approach**Figure 3: Illustrating the effect on changes in prepayments in a top layer approach**

BC198 Finally, if some assets prepay *later* than expected so that the entity revises *upward* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, see figures 2(c) and 3(c)), no ineffectiveness arises no matter how the layer is designated, on the grounds that the hedged layer of CU20 is still there and that was all that was being hedged.

Percentage approach

BC199 The percentage approach, illustrated in figure 4, designates the hedged item as a percentage of the assets (or liabilities) in a repricing time period. In this approach, in the portfolio in the above example, 20 per cent of the assets of CU100 in this repricing time period is designated as the hedged item (figure 4(a)). As a result, if some assets prepay *earlier* than expected so that the entity revises *downwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU90, figure 4(b)), ineffectiveness arises on 20 per cent of the decrease (in this case ineffectiveness arises on CU2). Similarly, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, figure 4(c)), ineffectiveness arises on 20 per cent of the increase (in this case ineffectiveness arises on CU2).

Figure 4: Illustrating the designation of an amount of assets as a percentage



Arguments for and against the layer approach

BC200 The arguments for the layer approach are as follows:

- (a) Designating a bottom layer would be consistent with the answers to Questions F.6.1 and F.6.2 of the Guidance on Implementing IAS 39, which allow, for a cash flow hedge, the 'bottom' portion of reinvestments of collections from assets to be designated as the hedged item.*
- (b) The entity is hedging interest rate risk rather than prepayment risk. Any changes to the portfolio because of changes in prepayments do not affect how effective the hedge was in mitigating interest rate risk.
- (c) The approach captures all ineffectiveness on the hedged portion. It merely allows the hedged portion to be defined in such a way that, at least in a bottom layer approach, the first of any potential ineffectiveness relates to the unhedged portion.

* IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39.

- (d) It is correct that no ineffectiveness arises if changes in prepayment estimates cause more assets to be scheduled into that repricing time period. So long as assets equal to the hedged layer remain, there is no ineffectiveness and upward revisions of the amount in a repricing time period do not affect the hedged layer.
- (e) A prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. The designation of a bottom layer can be viewed as hedging a part of the life of the non-prepayable item, but none of the prepayment option. For example, a 25-year prepayable mortgage can be viewed as a combination of (i) a non-prepayable, fixed term, 25-year mortgage and (ii) a written prepayment option that allows the borrower to repay the mortgage early. If the entity hedges this asset with a 5-year derivative, this is equivalent to hedging the first five years of component (i). If the position is viewed in this way, no ineffectiveness arises when interest rate changes cause the value of the prepayment option to change (unless the option is exercised and the asset prepaid) because the prepayment option was not hedged.

BC201 The arguments against the layer approach are as follows:

- (a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.
- (b) The fact that no ineffectiveness is recognised if the amount in a repricing time period is re-estimated upwards (with the effect that the entity becomes underhedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both when the entity becomes overhedged (ie the derivative exceeds the hedged item) and when it becomes underhedged (ie the derivative is smaller than the hedged item).
- (c) As noted in paragraph BC200(e), a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. When interest rates change, the fair value of both of these components changes.
- (d) The objective of applying fair value hedge accounting to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain results that closely approximate those that would have been obtained if individual assets or liabilities had been designated as the hedged item. If individual prepayable assets had been designated as the hedged item, the change in both the components noted in (c) above (to the extent they are attributable to the hedged risk) would be recognised in profit or loss, both when interest rates increase and when they decrease. Accordingly, the change in the fair value of the hedged asset would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that in the simplified approach of designating the hedged item as an amount, ineffectiveness should similarly arise.
- (e) *All* prepayable assets in a repricing time period, and not just a layer of them, contain a prepayment option whose fair value changes with changes in interest rates. Accordingly, when interest rates change, the fair value of the hedged assets (which include a prepayment option whose fair value has changed) will change by an amount different from that of the hedging derivative (which typically does not contain a prepayment option), and ineffectiveness will arise. This effect

occurs regardless of whether interest rates increase or decrease—ie regardless of whether re-estimates of prepayments result in the amount in a time period being more or less.

- (f) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item. Often the biggest single cause of changes in prepayment rates is changes in interest rates. This close relationship is the reason why IAS 39^{***} prohibits a held-to-maturity asset⁺ from being a hedged item with respect to either interest rate risk or prepayment risk. Furthermore, most entities do not separate the two components for risk management purposes. Rather, they incorporate the prepayment option by scheduling amounts based on expected maturities. When entities choose to use risk management practices—based on not separating prepayment and interest rate risk—as the basis for designation for hedge accounting purposes, it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item.
- (g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be different from the effect on the fair value of a portfolio of otherwise identical but non-prepayable items. However, using a layer approach, this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

BC202 The Board was persuaded by the arguments in paragraph BC201 and rejected layer approaches. In particular, the Board concluded that the hedged item should be designated in such a way that if the entity changes its estimates of the repricing time periods in which items are expected to repay or mature (eg in the light of recent prepayment experience), ineffectiveness arises. It also concluded that ineffectiveness should arise both when estimated prepayments decrease, resulting in more assets in a particular repricing time period, and when they increase, resulting in fewer.

Arguments for a third approach—measuring directly the change in fair value of the entire hedged item

BC203 The Board also considered comments on the Exposure Draft that:

- (a) some entities hedge prepayment risk and interest rate risk separately, by hedging to the expected prepayment date using interest rate swaps, and hedging possible variations in these expected prepayment dates using swaptions.
- (b) the embedded derivatives provisions of IAS 39 require some prepayable assets to be separated into a prepayment option and a non-prepayable host contract^{*} (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for trading^{**}). This seems to conflict with the view in the Exposure Draft that the two risks are too difficult to separate for the purposes of a portfolio hedge.[#]

BC204 In considering these arguments, the Board noted that the percentage approach described in paragraph AG126(b) is a proxy for measuring the change in the fair value of the *entire*

^{***}—see IAS 39, paragraph 79

⁺ IFRS 9 eliminated the category of held-to-maturity.

^{*}—see IAS 39, paragraphs 11 and AG30(g)

^{**}—see IAS 39, paragraph 12

[#] IFRS 9 replaced IAS 39.

asset (or liability)—including any embedded prepayment option—that is attributable to changes in interest rates. The Board had developed this proxy in the Exposure Draft because it had been informed that most entities (a) do not separate interest rate risk and prepayment risk for risk management purposes and hence (b) were unable to value the change in the value of the entire asset (including any embedded prepayment option) that is attributable to changes in the hedged interest rates. However, the comments described in paragraph BC203 indicated that in some cases, entities may be able to measure this change in value directly. The Board noted that such a direct method of measurement is conceptually preferable to the proxy described in paragraph AG126(b) and, accordingly, decided to recognise it explicitly. Thus, for example, if an entity that hedges prepayable assets using a combination of interest rate swaps and swaptions is able to measure directly the change in fair value of the entire asset, it could measure effectiveness by comparing the change in the value of the swaps and swaptions with the change in the fair value of the entire asset (including the change in the value of the prepayment option embedded in them) that is attributable to changes in the hedged interest rate. However, the Board also decided to permit the proxy proposed in the Exposure Draft for those entities that are unable to measure directly the change in the fair value of the entire asset.

Consideration of systems requirements

BC205 Finally, the Board was informed that, to be practicable in terms of systems needs, any approach should not require tracking of the amount in a repricing time period for multiple periods. Therefore it decided that ineffectiveness should be calculated by determining the change in the estimated amount in a repricing time period between one date on which effectiveness is measured and the next, as described more fully in paragraphs AG126 and AG127. This requires the entity to track how much of the change in each repricing time period between these two dates is attributable to revisions in estimates and how much is attributable to the origination of new assets (or liabilities). However, once ineffectiveness has been determined as set out above, the entity in essence starts again, ie it establishes the new amount in each repricing time period (including new items that have been originated since it last tested effectiveness), designates a new hedged item, and repeats the procedures to determine ineffectiveness at the next date it tests effectiveness. Thus the tracking is limited to movements between one date when effectiveness is measured and the next. It is not necessary to track for multiple periods. However, the entity will need to keep records relating to each repricing time period (a) to reconcile the amounts for each repricing time period with the total amounts in the two separate line items in the balance sheet (see paragraph AG114(f)), and (b) to ensure that amounts in the two separate line items are derecognised no later than when the repricing time period to which they relate expires.

BC206 The Board also noted that the amount of tracking required by the percentage approach is no more than what would be required by any of the layer approaches. Thus, the Board concluded that none of the approaches was clearly preferable from the standpoint of systems needs.

The carrying amount of the hedged item

BC207 The last issue noted in paragraph BC176 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands of—individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a decrease in the fair value of a financial asset (financial

liability) being recognised as a financial liability (financial asset). Furthermore, for some repricing time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such repricing time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.

BC208 Accordingly, the Board decided that two line items should be presented, as follows:

- (a) for those repricing time periods for which the hedged item is an asset, the change in its fair value is presented in a single separate line item within assets; and
- (b) for those repricing time periods for which the hedged item is a liability, the change in its fair value is presented in a single separate line item within liabilities.

BC209 The Board noted that these line items represent changes in the fair value of the hedged item. For this reason, the Board decided that they should be presented next to financial assets or financial liabilities.

Derecognition of amounts included in the separate line items

Derecognition of an asset (or liability) in the hedged portfolio

BC210 The Board discussed how and when amounts recognised in the separate balance sheet line items should be removed from the balance sheet. The Board noted that the objective is to remove such amounts from the balance sheet in the same periods as they would have been removed had individual assets or liabilities (rather than an amount) been designated as the hedged item.

BC211 The Board noted that this objective could be fully met only if the entity schedules individual assets or liabilities into repricing time periods and tracks both for how long the scheduled individual items have been hedged and how much of each item was hedged in each time period. In the absence of such scheduling and tracking, some assumptions would need to be made about these matters and, hence, about how much should be removed from the separate balance sheet line items when an asset (or liability) in the hedged portfolio is derecognised. In addition, some safeguards would be needed to ensure that amounts included in the separate balance sheet line items are removed from the balance sheet over a reasonable period and do not remain in the balance sheet indefinitely. With these points in mind, the Board decided to require that:

- (a) whenever an asset (or liability) in the hedged portfolio is derecognised—whether through earlier than expected prepayment, sale or write-off from impairment—any amount included in the separate balance sheet line item relating to that derecognised asset (or liability) should be removed from the balance sheet and included in the gain or loss on derecognition.
- (b) if an entity cannot determine into which time period(s) a derecognised asset (or liability) was scheduled:
 - (i) it should assume that higher than expected prepayments occur on assets scheduled into the first available time period; and
 - (ii) it should allocate sales and impairments to assets scheduled into all time periods containing the derecognised item on a systematic and rational

basis.

- (c) the entity should track how much of the total amount included in the separate line items relates to each repricing time period, and should remove the amount that relates to a particular time period from the balance sheet no later than when that time period expires.

Amortisation

BC212 The Board also noted that if the designated hedged amount for a repricing time period is reduced, IAS 39* requires that the separate balance sheet line item described in paragraph 89A relating to that reduction is amortised on the basis of a recalculated effective interest rate. The Board noted that for a portfolio hedge of interest rate risk, amortisation based on a recalculated effective interest rate could be complex to determine and could demand significant additional systems requirements. Consequently, the Board decided that in the case of a portfolio hedge of interest rate risk (and only in such a hedge), the line item balance may be amortised using a straight-line method when a method based on a recalculated effective interest rate is not practicable.

The hedging instrument

BC213 The Board was asked by commentators to clarify whether the hedging instrument may be a portfolio of derivatives containing offsetting risk positions. Commentators noted that previous versions of IAS 39 were unclear on this point.

BC214 The issue arises because the assets and liabilities in each repricing time period change over time as prepayment expectations change, as items are derecognised and as new items are originated. Thus the net position, and the amount the entity wishes to designate as the hedged item, also changes over time. If the hedged item decreases, the hedging instrument needs to be reduced. However, entities do not normally reduce the hedging instrument by disposing of some of the derivatives contained in it. Instead, entities adjust the hedging instrument by entering into new derivatives with an offsetting risk profile.

BC215 The Board decided to permit the hedging instrument to be a portfolio of derivatives containing offsetting risk positions for both individual and portfolio hedges. It noted that all of the derivatives concerned are measured at fair value. It also noted that the two ways of adjusting the hedging instrument described in the previous paragraph can achieve substantially the same effect. Therefore the Board clarified paragraph 77 to this effect.

Hedge effectiveness for a portfolio hedge of interest rate risk

BC216 Some respondents to the Exposure Draft questioned whether IAS 39's effectiveness tests** should apply to a portfolio hedge of interest rate risk. The Board noted that its objective in amending IAS 39 for a portfolio hedge of interest rate risk is to permit fair value hedge accounting to be used more easily, whilst continuing to meet the principles of hedge accounting. One of these principles is that the hedge is highly effective. Thus, the Board concluded that the effectiveness requirements in IAS 39 apply equally to a portfolio hedge of interest rate risk.

* see paragraph 92

** see paragraph AG105

- BC217 Some respondents to the Exposure Draft sought guidance on how the effectiveness tests are to be applied to a portfolio hedge. In particular, they asked how the prospective effectiveness test is to be applied when an entity periodically ‘rebalances’ a hedge (ie adjusts the amount of the hedging instrument to reflect changes in the hedged item). The Board decided that if the entity’s risk management strategy is to change the amount of the hedging instrument periodically to reflect changes in the hedged position, that strategy affects the determination of the term of the hedge. Thus, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. The Board noted that this decision does not conflict with the requirement in paragraph 75 that “a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding”. This is because the entire hedging instrument is designated (and not only some of its cash flows, for example, those to the time when the hedge is next adjusted). However, expected effectiveness is assessed by considering the change in the fair value of the entire hedging instrument only for the period until it is next adjusted.
- BC218 A third issue raised in the comment letters was whether, for a portfolio hedge, the retrospective effectiveness test should be assessed for all time buckets in aggregate or individually for each time bucket. The Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.

Transition to fair value hedge accounting for portfolios of interest rate risk

- BC219 In finalising the amendments to IAS 39, the Board considered whether to provide additional guidance for entities wishing to apply fair value hedge accounting to a portfolio hedge that had previously been accounted for using cash flow hedge accounting. The Board noted that such entities could apply paragraph 101(d) to revoke the designation of a cash flow hedge and re-designate a new fair value hedge using the same hedged item and hedging instrument, and decided to clarify this in the Application Guidance. Additionally, the Board concluded that clarification was not required for first-time adopters because IFRS 1 already contained sufficient guidance.
- BC220 The Board also considered whether to permit retrospective designation of a portfolio hedge. The Board noted that this would conflict with the principle in paragraph 88(a) that ‘at the inception of the hedge there is formal designation and documentation of the hedging relationship’ and accordingly, decided not to permit retrospective designation.

Novation of derivatives and continuation of hedge accounting

- BC220A The IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument in accordance with IAS 39 when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.*

* In this context, the term ‘novation’ indicates that the parties to a derivative agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.

- BC220B The IASB considered the derecognition requirements of IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing derivative that has been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).
- BC220C The IASB observed that paragraph 17(a) of IAS 39 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus the original derivative with Party B has expired and as a consequence the original derivative through which Party A has engaged with Party B shall meet the derecognition criteria for a financial asset.*
- BC220D The IASB also observed that paragraph AG57(b) of IAS 39 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and also would oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.†
- BC220E Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.
- BC220F Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered paragraphs 91(a) and 101(a) of IAS 39, which require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.
- BC220G The IASB, however, was concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation. The IASB also noted that there would be an increased risk that the hedging relationship would fail to fall within the 80–125 per cent hedge effectiveness range required by IAS 39.
- BC220H The IASB, taking note of these financial reporting effects, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The IASB also considered the feedback from outreach that involved

* IFRS 9 replaced IAS 39.

† IFRS 9 replaced IAS 39.

the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.

- BC220I The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.
- BC220J The IASB also considered the draft requirements of the forthcoming hedge accounting chapter of IFRS 9. The IASB noted that those draft requirements also would require hedge accounting to be discontinued if the novation to a CCP occurs.
- BC220K Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* ('ED/2013/2'), which proposed amendments to IAS 39 and IFRS 9. In ED/2013/2, the IASB proposed to amend paragraphs 91(a) and 101(a) of IAS 39 to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets certain criteria. The IASB decided to set the comment period for those proposals to 30 days. The IASB noted that the reduced comment period was necessary because the amendments should be completed urgently because the new laws or regulations to effect CCP clearing of OTC derivatives would come into force within a short period; the contents of the proposed amendments were short; and there was likely to be a broad consensus on the topic.
- BC220L When developing ED/2013/2, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty, however, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of or are incidental to the novation were acknowledged in the proposed amendments. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates, or the contractual cash flows or the basis of their calculation, except for charges that may arise as a consequence of transacting with a CCP.
- BC220M When developing ED/2013/2, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB tentatively decided that it was not appropriate to mandate specific disclosure in this situation because, from the perspective of a user of financial statements, the hedge accounting would be continuing.
- BC220N A total of 78 respondents commented on ED/2013/2. The vast majority of respondents agreed that the proposed amendments are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that IAS 39 expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if '[a] replacement or rollover is part of the entity's documented hedging strategy' (IAS 39.91(a) and IAS 39.101(a)). The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented hedging strategy'.

BC220O Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposed amendments. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope therefore should be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.

BC220P In considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation due to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.

BC220Q The IASB observed, however, that for hedge accounting to continue voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws or regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.

BC220R Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation also can occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.

BC220S On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting clearing with a CCP rather than limiting relief to situations in which novation is directly to a CCP. The IASB decided that in these circumstances the novation had occurred in order to effect clearing through a CCP, albeit indirectly. The IASB thus decided also to include such novations in the scope of the amendments because they are consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

BC220T Respondents raised a concern about the phrase 'if and only if' that was used in ED/2013/2 when describing that the relief is provided 'if and only if' the criteria are met. In considering respondents' comments, the IASB noted that ED/2013/2 was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase 'if and only if' to 'if' would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).

BC220U The IASB decided to make equivalent amendments to the forthcoming chapter on hedge accounting that will be incorporated into IFRS 9, as proposed in ED/2013/2; no respondents opposed this proposal.

BC220V ED/2013/2 did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*, which requires qualitative and quantitative disclosures about credit risk.

BC220W The IASB also decided to retain in the final amendments the transition requirements proposed in ED/2013/2 so that the amendments should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting, as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).

Elimination of selected differences from US GAAP

BC221-~~[Deleted]~~

BC222 ~~The Board considered opportunities to eliminate differences between IAS 39 and US GAAP. The guidance on measurement and hedge accounting under revised IAS 39 is generally similar to that under US GAAP. The amendments will further reduce or eliminate differences between IAS 39 and US GAAP in the areas listed below. In some other areas, a difference will remain. For example, US GAAP in many, but not all, areas is more detailed, which may result in a difference in accounting when an entity applies an accounting approach under IAS 39 that would not be permitted under US GAAP.~~

~~*Contracts to buy or sell a non-financial item*~~

- (a) ~~The Board decided that a contract to buy or sell a non-financial item is a derivative within the scope of IAS 39 if the non-financial item that is the subject of the contract is readily convertible to cash and the contract is not a 'normal' purchase or sale. This requirement is comparable to the definition of a derivative in SFAS 133, which also includes contracts for which the underlying is readily convertible to cash, and to the scope exclusion in SFAS 133 for 'normal' purchases and sales.~~

~~*Scope: loan commitments*~~

- (b) ~~The Board decided to add a paragraph to IAS 39 to exclude particular loan commitments that are not settled net. Such loan commitments were within the scope of the original IAS 39. The amendment moves IAS 39 closer to US GAAP.~~

~~*Unrealised gains and losses on available-for-sale financial assets*~~

- (e) — The Board decided to eliminate the option to recognise in profit or loss gains and losses on available-for-sale financial assets (IAS 39, paragraph 55(b)), and thus require such gains and losses to be recognised in equity.^a The change is consistent with SFAS 115, which does not provide the option in the original IAS 39 to recognise gains and losses on available-for-sale financial assets in profit or loss. SFAS 115 requires those unrealised gains and losses to be recognised in other comprehensive income (not profit or loss).

~~*Fair value in active markets*~~

- (d) — The Board decided to amend the wording in IAS 39, paragraph AG71, to state that, instead of a quoted market price *normally* being the best evidence of fair value, a quoted market price *is* the best evidence of fair value. This is similar to SFAS 107 *Disclosures about Fair Value of Financial Instruments*.

~~*Fair value in inactive markets*~~

- (e) — The Board decided to include in IAS 39 a requirement that the best evidence of the fair value of an instrument that is not traded in an active market is the transaction price, unless the fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique incorporating only observable market data. This is similar to the requirements of EITF 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.

~~*Impaired fixed rate loans: observable market price*~~

- (f) — The Board decided to permit an impaired fixed interest rate loan to be measured using an observable market price. SFAS 114 allows impairment to be measured on the basis of a loan's observable market price.

~~*Reversal of impairment losses on investments in equity instruments*~~

- (g) — The Board decided that if an entity recognises an impairment loss on an available-for-sale equity investment and the fair value of the investment subsequently increases, the increase in fair value should be recognised in equity. This is comparable to US GAAP under which reversals of impairment losses are not permitted.

~~*Hedges of firm commitments*~~

- (h) — The Board decided to require hedges of firm commitments to be treated as fair value hedges instead of cash flow hedges as was required under the original IAS 39 (except foreign currency risk when the hedge may be designated as either a cash flow hedge or a fair value hedge). This change brings IAS 39 closer to SFAS 133.

~~*Basis adjustments to financial assets or financial liabilities resulting from hedges of*~~

^a — As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

~~forecast transactions—~~

- (i) ~~—Basis adjustments to financial assets or financial liabilities resulting from hedges of forecast transactions are not permitted under SFAS 133. The revised IAS 39 also precludes such basis adjustments.—~~

~~Basis adjustments to non financial assets or non financial liabilities resulting from hedges of forecast transactions—~~

- (j) ~~—The Board decided to permit entities to apply basis adjustments to non financial assets or non financial liabilities that result from hedges of forecast transactions. Although US GAAP precludes basis adjustments, permitting a choice in IAS 39 allows entities to meet the US GAAP requirements.—~~

~~Summary of changes from the Exposure Draft—~~

~~BC222 The main changes from the Exposure Draft's proposals are as follows:—~~

~~—Scope—~~

- (a) ~~—The Standard adopts the proposal in the Exposure Draft that loan commitments that cannot be settled net and are not classified at fair value through profit or loss are excluded from the scope of the Standard. The Standard requires, however, that a commitment to extend a loan at a below market interest rate is initially recognised at fair value, and subsequently measured at the higher of (i) the amount determined under IAS 37 and (ii) the amount initially recognised, less where appropriate, cumulative amortisation recognised in accordance with IAS 18.* —~~
- (b) ~~—The Standard adopts the proposal in the Exposure Draft that financial guarantees are initially recognised at fair value, but clarifies that subsequently they are measured at the higher of (a) the amount determined under IAS 37 and (b) the amount initially recognised, less, where appropriate, cumulative amortisation recognised in accordance with IAS 18.* —~~

~~Definitions—~~

- (c) ~~—The Standard amends the definition of 'originated loans and receivables' to 'loans and receivables'. Under the revised definition, an entity is permitted to classify as loans and receivables purchased loans that are not quoted in an active market.—~~
- (d) ~~—The Standard amends the definition of transaction costs in the Exposure Draft to include internal costs, provided they are incremental and directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.—~~
- (e) ~~—The Standard amends the definition of the effective interest rate proposed in the Exposure Draft so that the effective interest rate is calculated using estimated cash flows for all instruments. An exception is made for those rare cases in which it is not possible to estimate cash flows reliably, when the Standard requires the—~~

* ~~—IFRS 15 Revenue from Contracts with Customers, issued in May 2014, replaced IAS 18 Revenue and amended paragraph 47 of IAS 39 for consistency with the requirements in IFRS 15.~~

~~use of contractual cash flows over the contractual life of the instrument. The Standard further stipulates that when accounting for a change in estimates, entities adjust the carrying amount of the instrument in the period of change with a corresponding gain or loss recognised in profit or loss. To calculate the new carrying amount, entities discount revised estimated cash flows at the original effective rate.~~

~~Derecognition of a financial asset~~

~~(f) The Exposure Draft proposed that an entity would continue to recognise a financial asset to the extent of its continuing involvement in that asset. Hence, an entity would derecognise a financial asset only if it did not have any continuing involvement in that asset. The Standard uses the concepts of control and of risks and rewards of ownership to determine whether, and to what extent, a financial asset is derecognised. The continuing involvement approach applies only if an entity retains some, but not substantially all, the risks and rewards of ownership and also retains control (see also (i) below).~~

~~(g) Unlike the Exposure Draft, the Standard clarifies when a part of a larger financial asset should be considered for derecognition. The Standard requires a part of a larger financial asset to be considered for derecognition if, and only if, the part is one of:~~

- ~~• only specifically identified cash flows from a financial asset;~~
- ~~• only a fully proportionate (pro rata) share of the cash flows from a financial asset; or~~
- ~~• only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset.~~

~~In all other cases, the Standard requires the financial asset to be considered for derecognition in its entirety.~~

~~(h) The Standard retains the conditions proposed in the Exposure Draft for ‘pass-through arrangements’ in which an entity retains the contractual rights to receive cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities. However, because of confusion over the meaning of the term ‘pass-through arrangements’, the Standard does not use this term.~~

~~(i) The Standard requires that an entity first assesses whether it has transferred substantially all the risks and rewards of ownership. If an entity has retained substantially all such risks and rewards, it continues to recognise the transferred asset. If it has transferred substantially all such risks and rewards, it derecognises the transferred asset. If an entity has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred asset, it assesses whether it has retained control over the transferred asset. If it has retained control, the Standard requires the entity to continue recognising the transferred asset to the extent of its continuing involvement in the transferred asset. If it has not retained control, the entity derecognises the transferred asset.~~

~~(j) The Standard provides guidance on how to evaluate the concepts of risks and rewards and of control for derecognition purposes.~~

~~Measurement~~

- ~~(k) — The Standard adopts the option proposed in the Exposure Draft to permit designation of any financial asset or financial liability on initial recognition as one to be measured at fair value, with changes in fair value recognised in profit or loss. However, the Standard clarifies that the fair value of liabilities with a demand feature, for example, demand deposits, is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid.~~
- ~~(l) — The Standard adopts the proposal in the Exposure Draft that quoted prices in active markets should be used to determine fair value in preference to other valuation techniques. The Standard adds guidance that if a rate (rather than a price) is quoted, these quoted rates are used as inputs into valuation techniques to determine the fair value. The Standard further clarifies that if an entity operates in more than one active market, the entity uses the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market to which the entity has immediate access.~~
- ~~(m) — The Standard simplifies the fair value measurement hierarchy in an inactive market so that recent market transactions do not take precedence over a valuation technique. Rather, when there is not a price in an active market, a valuation technique is used. Such valuation techniques include using recent arm's length market transactions.~~
- ~~(n) — The Standard also clarifies that the best estimate of fair value at initial recognition of a financial instrument that is not quoted in an active market is the transaction price, unless the fair value of the instrument is evidenced by other observable market transactions or is based on a valuation technique whose variables include only data from observable markets.~~

~~Impairment of financial assets~~

- ~~(o) — The Standard clarifies that an impairment loss is recognised only when it has been incurred. The Standard eliminates some of the detailed guidance in the Exposure Draft, in particular, the example of how to calculate the discount rate for the purpose of measuring impairment in a group of financial assets.~~
- ~~(p) — The Exposure Draft proposed that impairment losses recognised on investments in debt or equity instruments that are classified as available for sale cannot be reversed through profit or loss. The Standard requires that for available for sale debt instruments, an impairment loss is reversed through profit or loss when fair value increases and the increase can be objectively related to an event occurring after the loss was recognised. Impairment losses recognised on available for sale equity instruments cannot be reversed through profit or loss, ie any subsequent increase in fair value is recognised in equity.^a~~

~~Hedge accounting~~

- ~~(q) — The Standard requires that when a hedged forecast transaction actually occurs and results in the recognition of a financial asset or a financial liability, the gain~~

^a — As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such an increase is recognised in other comprehensive income.

or loss deferred in equity does not adjust the initial carrying amount of the asset or liability (ie 'basis adjustment' is prohibited), but remains in equity and is recognised in profit or loss consistently with the recognition of gains and losses on the asset or liability. For hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability, the entity has a choice of whether to apply basis adjustment or retain the hedging gain or loss in equity and recognise it in profit or loss when the asset or liability affects profit or loss.

- (r) — The Exposure Draft proposed to treat hedges of firm commitments as fair value hedges (rather than as cash flow hedges). The Standard adopts this requirement but clarifies that a hedge of the foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or a cash flow hedge.
- (s) — The Exposure Draft maintained the prior guidance that a forecast intragroup transaction may be designated as the hedged item in a foreign currency cash flow hedge provided the transaction is highly probable, meets all other hedge accounting criteria, and will result in the recognition of an intragroup monetary item. The Standard (as revised in 2003) did not include this guidance in the light of comments received from some constituents questioning its conceptual basis. After the revised Standard was issued, constituents raised concerns that it was common practice for entities to designate a forecast intragroup transaction as the hedged item and that the revised IAS 39 created a difference from US GAAP. In response to these concerns, the Board published an Exposure Draft in July 2004. That Exposure Draft proposed to allow an entity to apply hedge accounting in the consolidated financial statements to a highly probable forecast external transaction denominated in the functional currency of the entity entering into the transaction, provided the transaction gave rise to an exposure that would have an effect on the consolidated profit or loss (ie was denominated in a currency other than the group's presentation currency). After discussing the comment letters received on that Exposure Draft, the Board decided to permit the foreign currency risk of a forecast intragroup transaction to be the hedged item in a cash flow hedge in consolidated financial statements provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. In issuing this amendment the Board concluded that:
 - (i) — allowing a forecast intragroup transaction to be designated as the hedged item in consolidated financial statements is consistent with the functional currency framework in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, which recognises a functional currency exposure whenever a transaction (including a forecast transaction) is denominated in a currency different from the functional currency of the entity entering into the transaction.
 - (ii) — allowing a forecast transaction (intragroup or external) to be designated as the hedged item in consolidated financial statements would not be consistent with the functional currency framework in IAS 21 if the transaction is denominated in the functional currency of the entity entering into it. Accordingly, such transactions should not be permitted to be designated as hedged items in a foreign currency cash flow hedge.
 - (iii) — it is consistent with paragraphs 97 and 98 that any gain or loss that is

~~recognised directly in equity[†] in a cash flow hedge of a forecast intragroup transaction should be reclassified into consolidated profit or loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.~~

~~Transition~~

- (t) ~~The revised Standard adopts the proposal in the Exposure Draft that, on transition, an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or a financial liability at fair value through profit or loss or available for sale. However, a disclosure requirement has been added to IAS 32^{*} to provide information about the fair value of the financial assets or financial liabilities designated into each category and the classification and carrying amount in the previous financial statements.~~
- (u) ~~The Exposure Draft proposed retrospective application of the derecognition provisions of the revised IAS 39 to financial assets derecognised under the original IAS 39. The Standard requires prospective application, namely that entities do not recognise those assets that were derecognised under the original Standard, but permits retrospective application from a date of the entity's choosing, provided that the information needed to apply IAS 39 to assets and liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.~~
- (v) ~~The Exposure Draft proposed, and the revised Standard originally required, retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76. After the revised Standard was issued, constituents raised concerns that retrospective application would diverge from the requirements of US GAAP, would be difficult and expensive to implement, and might require subjective assumptions about what was observable and what was not. In response to these concerns, the Board decided:~~
- (i) ~~to permit entities to apply the requirements in the last sentence of paragraph AG76 in any one of the following ways:~~
- ~~• retrospectively, as previously required by IAS 39~~
 - ~~• prospectively to transactions entered into after 25 October 2002, the effective date of equivalent US GAAP requirements~~
 - ~~• prospectively to transactions entered into after 1 January 2004, the date of transition to IFRSs for many entities.~~
- (ii) ~~to clarify that a gain or loss should be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price. Some constituents asked the Board to clarify that straight line amortisation is an appropriate method of recognising the difference between a transaction price (used as fair value in accordance with paragraph AG76) and a valuation made at the time of the transaction that was not based solely on data from observable markets. The Board decided not to do this. It concluded that although straight line amortisation may be an~~

[†] As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such a gain or loss is recognised in other comprehensive income.

^{*} In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

appropriate method in some cases, it will not be appropriate in others.

~~Dissenting opinions~~

~~Dissent of Anthony T Cope, James J Leisenring and Warren J McGregor from the issue of IAS 39 in December 2003~~

- ~~DO1—Messrs Cope, Leisenring and McGregor dissent from the issue of this Standard.~~
- ~~DO2—Mr Leisenring dissents because he disagrees with the conclusions concerning derecognition, impairment of certain assets and the adoption of basis adjustment hedge accounting in certain circumstances.~~
- ~~DO3—The Standard requires in paragraphs 30 and 31 that to the extent of an entity's continuing involvement in an asset, a liability should be recognised for the consideration received. Mr Leisenring believes that the result of that accounting is to recognise assets that fail to meet the definition of assets and to record liabilities that fail to meet the definition of liabilities. Furthermore, the Standard fails to recognise forward contracts, puts or call options and guarantees that are created, but instead records a fictitious 'borrowing' as a result of rights and obligations created by those contracts. There are other consequences of the continuing involvement approach that has been adopted. For transferors, it results in very different accounting by two entities when they have identical contractual rights and obligations only because one entity once owned the transferred financial asset. Furthermore, the 'borrowing' that is recognised is not accounted for like other loans, so no interest expense may be recorded. Indeed, implementing the proposed approach requires the specific override of measurement and presentation standards applicable to other similar financial instruments that do not arise from derecognition transactions. For example, derivatives created by derecognition transactions are not accounted for at fair value. For transferees, the approach also requires the override of the recognition and measurement requirements applicable to other similar financial instruments. If an instrument is acquired in a transfer transaction that fails the derecognition criteria, the transferee recognises and measures it differently from an instrument that is acquired from the same counterparty separately.~~
- ~~DO4—Mr Leisenring also disagrees with the requirement in paragraph 64 to include an asset that has been individually judged not to be impaired in a portfolio of similar assets for an additional portfolio assessment of impairment. Once an asset is judged not to be impaired, it is irrelevant whether the entity owns one or more similar assets as those assets have no implications for whether the asset that was individually considered for impairment is or is not impaired. The result of this accounting is that two entities could each own 50 per cent of a single loan. Both entities could conclude the loan is not impaired. However, if one of the two entities happens to have other loans that are similar, it would be allowed to recognise an impairment with respect to the loan where the other entity is not. Accounting for identical exposures differently is unacceptable. Mr Leisenring believes that the arguments in paragraph BC115 are compelling.~~
- ~~DO5—Mr Leisenring also dissents from paragraph 98 which allows but does not require basis adjustment for hedges of forecast transactions that result in the recognition of non financial assets or liabilities. This accounting results in always adjusting the recorded asset or liability at the date of initial recognition away from its fair value. It also records an asset, if the basis adjustment alternative is selected, at an amount other than its cost as defined in IAS 16 *Property, Plant and Equipment* and further described in paragraph 16 of that Standard. If a derivative were to be considered a part of the cost of acquiring an~~

~~asset, hedge accounting in these circumstances should not be elective to be consistent with IAS 16. Mr Leisenring also objects to creating this alternative as a result of an improvement project that ostensibly had as an objective the reduction of alternatives. The non-comparability that results from this alternative is both undesirable and unnecessary.~~

- ~~DO6—Mr Leisenring also dissents from the application guidance in paragraph AG71 and in particular the conclusion contained in paragraph BC98. He does not believe that an entity that originates a contract in one market should measure the fair value of the contract by reference to a different market in which the transaction did not take place. If prices change in the transacting market, that price change should be recognised when subsequently measuring the fair value of the contract. However, there are many implications of switching between markets when measuring fair value that the Board has not yet addressed. Mr Leisenring believes a gain or loss should not be recognised based on the fact a transaction could occur in a different market.~~
- ~~DO7—Mr Cope dissents from paragraph 64 and agrees with Mr Leisenring's analysis and conclusions on loan impairment as set out above in paragraph DO4. He finds it counter-intuitive that a loan that has been determined not to be impaired following careful analysis should be subsequently accounted for as if it were impaired when included in a portfolio.~~
- ~~DO8—Mr Cope also dissents from paragraph 98, and, in particular, the Board's decision to allow a free choice over whether basis adjustment is used when accounting for hedges of forecast transactions that result in the recognition of non-financial assets or non-financial liabilities. In his view, of the three courses of action open to the Board—retaining IAS 39's requirement to use basis adjustment, prohibiting basis adjustment as proposed in the June 2002 Exposure Draft, or providing a choice—the Board has selected the worst course. Mr Cope believes that the best approach would have been to prohibit basis adjustment, as proposed in the Exposure Draft, because, in his opinion, basis adjustments result in the recognition of assets and liabilities at inappropriate amounts.~~
- ~~DO9—Mr Cope believes that increasing the number of choices in international standards is bad policy. The Board's decision potentially creates major differences between entities choosing one option and those choosing the other. This lack of comparability will adversely affect users' ability to make sound economic decisions.~~
- ~~DO10—In addition, Mr Cope notes that entities that are US registrants may choose not to adopt basis adjustment in order to avoid a large reconciling difference to US GAAP. Mr Cope believes that increasing differences between IFRS-compliant entities that are US registrants and those that are not is undesirable.~~
- ~~DO11—Mr McGregor dissents from paragraph 98 and agrees with Mr Cope's and Mr Leisenring's analyses and conclusions as set out above in paragraphs DO5 and DO8-DO10.~~
- ~~DO12—Mr McGregor also dissents from this Standard because he disagrees with the conclusions about impairment of certain assets.~~
- ~~DO13—Mr McGregor disagrees with paragraphs 67 and 69, which deal with the impairment of equity investments classified as available for sale. These paragraphs require impairment losses on such assets to be recognised in profit or loss when there is objective evidence that the asset is impaired. Previously recognised impairment losses are not to be reversed through profit and loss when the assets' fair value increases. Mr McGregor notes that the Board's reasoning for~~

~~prohibiting reversals through profit or loss of previously impaired available for sale equity investments, set out in paragraph BC130 of the Basis for Conclusions, is that it ‘..could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value’. He agrees with this reasoning but believes that it applies equally to the recognition of impairment losses in the first place. Mr McGregor believes that the significant subjectivity involved in assessing whether a reduction in fair value represents an impairment (and thus should be recognised in profit or loss) or another decrease in value (and should be recognised directly in equity) will at best lead to a lack of comparability within an entity over time and between entities, and at worst provide an opportunity for entities to manage reported profit or loss.~~

~~DO14 Mr McGregor believes that all changes in the fair value of assets classified as available for sale should be recognised in profit or loss. However, such a major change to the Standard would need to be subject to the Board’s full due process. At this time, to overcome the concerns expressed in paragraph DO13, he believes that for equity investments classified as available for sale, the Standard should require all changes in fair value below cost to be recognised in profit or loss as impairments and reversals of impairments and all changes in value above cost to be recognised in equity. This approach treats all changes in value the same way, no matter what their cause. The problem of how to distinguish an impairment loss from another decline in value (and of deciding whether there is an impairment in the first place) is eliminated because there is no longer any subjectivity involved. In addition, the approach is consistent with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.~~

~~DO15 Mr McGregor disagrees with paragraph 106 of the Standard and with the consequential amendments to paragraph 27^{*} of IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Paragraph 106 requires entities to apply the derecognition provisions prospectively to financial assets. Paragraph 27 of IFRS 1 requires first-time adopters to apply the derecognition provisions of IAS 39 (as revised in 2003) prospectively to non-derivative financial assets and financial liabilities. Mr McGregor believes that existing IAS 39 applicators should apply the derecognition provisions retrospectively to financial assets, and that first-time adopters should apply the derecognition provisions of IAS 39 retrospectively to all financial assets and financial liabilities. He is concerned that financial assets may have been derecognised under the original IAS 39 by entities that were subject to it, which might not have been derecognised under the revised IAS 39. He is also concerned that non-derivative financial assets and financial liabilities may have been derecognised by first-time adopters under previous GAAP that would not have been derecognised under the revised IAS 39. These amounts may be significant in many cases. Not requiring recognition of such amounts will result in the loss of relevant information and will impair the ability of users of financial statements to make sound economic decisions.~~

^{*} — As a result of the revision of IFRS 1 in November 2008, paragraph 27 became paragraph B2.

Dissent of John T Smith from the issue in March 2004 of *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Amendment to IAS 39)

- DO1 Mr Smith dissents from these Amendments to IAS 39 Financial Instruments: Recognition and Measurement *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. He agrees with the objective of finding a macro hedging solution that would reduce systems demands without undermining the fundamental accounting principles related to derivative instruments and hedging activities. However, Mr Smith believes that some respondents' support for these Amendments and their willingness to accept IAS 39 is based more on the extent to which the Amendments reduce recognition of ineffectiveness, volatility of profit or loss, and volatility of equity than on whether the Amendments reduce systems demands without undermining the fundamental accounting principles.
- DO2 Mr Smith believes some decisions made during the Board's deliberations result in an approach to hedge accounting for a portfolio hedge that does not capture what was originally intended, namely a result that is substantially equivalent to designating an individual asset or liability as the hedged item. He understands some respondents will not accept IAS 39 unless the Board provides still another alternative that will further reduce reported volatility. Mr Smith believes that the Amendments already go beyond their intended objective. In particular, he believes that features of these Amendments can be applied to smooth out ineffectiveness and achieve results substantially equivalent to the other methods of measuring ineffectiveness that the Board considered when developing the Exposure Draft. The Board rejected those methods because they did not require the immediate recognition of all ineffectiveness. He also believes those features could be used to manage earnings.

~~Dissent of Mary E Barth, Robert P Garnett and Geoffrey Whittington from the issue in June 2005 of *The Fair Value Option* (Amendments to IAS 39)~~

- ~~DO1—Professor Barth, Mr Garnett and Professor Whittington dissent from the amendment to IAS 39 Financial Instruments: Recognition and Measurement—*The Fair Value Option*. Their dissenting opinions are set out below.~~
- ~~DO2—These Board members note that the Board considered the concerns expressed by the prudential supervisors on the fair value option as set out in the December 2003 version of IAS 39 when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39 and providing relevant information to users of financial statements, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion. Furthermore, the majority of constituents have clearly expressed a preference for the fair value option as set out in the December 2003 version of IAS 39 over the fair value option as contained in the amendment.~~
- ~~DO3—Those Board members note that the amendment introduces a series of complex rules, including those governing transition which would be entirely unnecessary in the absence of the amendment. There will be consequential costs to preparers of financial statements, in order to obtain, in many circumstances, substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39. They believe that the complex rules will also inevitably lead to differing interpretations of the eligibility criteria for the fair value option contained in the amendment.~~
- ~~DO4—These Board members also note that, for paragraph 9(b)(i), application of the amendment may not mitigate, on an ongoing basis, the anomaly of volatility in profit or loss that results from the different measurement attributes in IAS 39 any more than would the option in the December 2003 version of IAS 39. This is because the fair value designation is required to be continued even if one of the offsetting instruments is derecognised. Furthermore, for paragraphs 9(b)(i), 9(b)(ii) and 11A, the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions that permitted the use of the option still hold. Therefore, these Board members question the purpose of and need for requiring the criteria to be met at initial designation.~~

~~Dissent of James J Leisenring and John T Smith from the issue in October 2008 of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7)~~

- ~~DO1 — Messrs Leisenring and Smith dissent from *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7). The amendments to IAS 39 are asserted to level the playing field with US GAAP. It accomplishes that with respect to the reclassification of financial instruments to the held-to-maturity category of loans and receivables from other classifications. However, once reclassified, the measurement of impairment and when that measurement is required are quite different and a level playing field in accounting for these instruments is not achieved. Messrs Leisenring and Smith would have been willing to support the alternative approach considered by the Board that would have closely aligned the impairment requirements of US GAAP with IFRSs.~~
- ~~DO2 — As described in paragraph BC11E, in October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP. SFAS 115 permits a security to be reclassified out of the trading category in rare situations. SFAS 65 permits a loan to be reclassified out of the Held for Sale category if the entity has the intention to hold the loan for the foreseeable future or until maturity. IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held-for-trading category as is permitted by SFAS 115 and SFAS 65.~~
- ~~DO3 — Messrs Leisenring and Smith both believe that the current requirements in IFRSs for reclassification are superior to US GAAP and that the accounting for impairments in US GAAP is superior to the requirements of IAS 39.~~
- ~~DO4 — Furthermore, Messrs Leisenring and Smith do not believe that amendments to standards should be made without any due process.~~

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IAS 39 *Financial Instruments: Recognition and Measurement* Illustrative example

This example accompanies, but is not part of, IAS 39.

Facts

- IE1 On 1 January 20X1, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.
- IE2 For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (ie it has 60 separate monthly time periods).^{*} The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.
- IE3 This example deals only with the repricing time period expiring in three months' time, ie the time period maturing on 31 March 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million[†] and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.
- IE4 Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap^{**} on 1 January 20x1 to pay a fixed rate and receive LIBOR, with a notional principal amount of CU20 million and a fixed life of three months.
- IE5 This example makes the following simplifying assumptions:
- (a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;
 - (b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and
 - (c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

^{*} In this example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

[†] In this example monetary amounts are denominated in 'currency units (CU)'.

^{**} The example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6 It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7 The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows.

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8 The fair value of the swap at various times during the period of the hedge is as follows.

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting treatment

IE9 On 1 January 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (ie the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 88(d) and AG119 of the Standard.

IE10 Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (31 January 20X1)

IE11 On 31 January 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12 The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)* (the swap is a liability).

IE13 Entity A computes the change in the fair value of the hedged item taking into account the change in estimated prepayments, as follows.

- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20 million ÷ CU100 million).
- (b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.

* see paragraph IE8

- (c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408⁺ × (CU19.2 million ÷ CU20 million)).

IE14 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU172,097	
Cr	Profit or loss (interest income)*		CU172,097

To recognise the interest received on the hedged amount (CU19.2 million).

Dr	Profit or loss (interest expense)	CU179,268	
Cr	Profit or loss (interest income)		CU179,268
Cr	Cash		Nil

To recognise the interest received and paid on the swap designated as the hedging instrument.

Dr	Profit or loss (loss)	CU47,408	
Cr	Derivative liability		CU47,408

To recognise the change in the fair value of the swap.

Dr	Separate line item in the statement of financial position	CU45,511	
Cr	Profit or loss (gain)		CU45,511

To recognise the change in the fair value of the hedged amount.

- IE15 The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of month 2

- IE16 On 1 February 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold 8 1/3 per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.
- IE17 On this basis, Entity A computes that it has sold 8 1/3 per cent of the assets allocated to the three-month time period, ie CU8 million (8 1/3 per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.** On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is 8 1/3 per cent of the total line item balance of CU45,511, ie CU3,793.

⁺ ie CU20,047,408 – CU20,000,000. See paragraph IE7

^{*} This example does not show how amounts of interest income and interest expense are calculated.

^{**} The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

- IE18 Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position.

Dr	Cash	CU8,018,400	
Cr	Asset		CU8,000,000
Cr	Separate line item in the statement of financial position		CU3,793
Cr	Profit or loss (gain)		CU14,607

To recognise the sale of the asset at fair value and to recognise a gain on sale.

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

- IE19 Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.
- IE20 Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.⁺ It also complies with the other designation requirements in paragraphs 88(a) and AG119 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in profit or loss, or is designated as the hedging instrument in a different hedge.^{*}
- IE21 As at 1 February 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6[†] million of assets. However, as at 1 February 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.^{*} The remaining separate line item in the statement of financial position of CU22,755⁺⁺ relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, ie it amortises CU22,755 over two months.
- IE22 Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

⁺ CU47,408 × 40 per cent

^{*} The entity could instead enter into an offsetting swap with a notional principal of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

[†] CU19.2 million – (8 1/3% × CU19.2 million)

^{*} CU41,718 × (CU8 million ÷ CU17.6 million)

⁺⁺ CU41,718 – CU18,963

End of month 2 (28 February 20X1)

IE23 On 28 February 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)[°] (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at 28 February 20x1 as CU8,009,518[✕].

IE24 Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	CU71,707	
Cr	Profit or loss (interest income)		CU71,707

To recognise the interest received on the hedged amount (CU8 million).

Dr	Profit or loss (interest expense)	CU71,707	
Cr	Profit or loss (interest income)		CU62,115
Cr	Cash		CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,445	
Cr	Profit or loss (gain)		CU9,445

*To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million)
(CU9,518 – CU18,963).*

Dr	Profit or loss (loss)	CU9,445	
Cr	Separate line item in the statement of financial position		CU9,445

*To recognise the change in the fair value of the hedged amount
(CU8,009,518 – CU8,018,963).*

IE25 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE26 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Profit or loss (loss)	CU11,378	
Cr	Separate line item in the statement of financial position		CU11,378 [*]

To recognise the amortisation charge for the period.

[°] CU23,795 [see paragraph IE8] $\times$ (CU8 million $\div$ CU20 million)

[✕] CU20,023,795 [see paragraph IE7] $\times$ (CU8 million $\div$ CU20 million)

^{*} CU22,755 $\div$ 2

End of month 3

IE27 During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20X1 the assets and the swap mature and all balances are recognised in profit or loss.

IE28 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU8,071,707	
Cr	Asset (statement of financial position)		CU8,000,000
Cr	Profit or loss (interest income)		CU71,707

To recognise the interest and cash received on maturity of the hedged amount (CU8 million).

Dr	Profit or loss (interest expense)	CU71,707	
Cr	Profit or loss (interest income)		CU62,115
Cr	Cash		CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,518	
Cr	Profit or loss (gain)		CU9,518

To recognise the expiry of the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Profit or loss (loss)	CU9,518	
Cr	Separate line item in the statement of financial position		CU9,518

To remove the remaining line item balance on expiry of the time period.

IE29 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE30 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Profit or loss (loss)	CU11,377	
Cr	Separate line item in the statement of financial position		CU11,377*

To recognise the amortisation charge for the period.

* CU22,755 ÷ 2

Summary

IE31 The tables below summarise:

- (a) changes in the separate line item in the statement of financial position;
- (b) the fair value of the derivative;
- (c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and
- (d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
	CU	CU	CU	CU	CU
Amount of asset hedged	20,000,000	19,200,000	8,000,000	8,000,000	8,000,000

(a) Changes in the separate line item in the statement of financial position

Brought forward:

Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)

Carried forward:

Balance to be amortised	Nil	Nil	22,755	11,377	Nil
Remaining balance	Nil	45,511	18,963	9,518	Nil

(b) The fair value of the derivative

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
CU20,000,000	Nil	47,408	-	-	-
CU12,000,000	Nil	-	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	-	18,963	9,518	Nil
Total	Nil	47,408	47,408	9,518	Nil

(c) Profit or loss effect of the hedge

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	Nil	(1,897)	N/A	Nil	Nil
Amortisation	Nil	Nil	N/A	(11,378)	(11,377)

In addition, there is a gain on sale of assets of CU14,607 at 1 February 20X1.

(d) Interest income and interest expense relating to the amount designated as hedged

Profit or loss recognised for the amount hedged	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Interest income					
- on the asset	Nil	172,097	N/A	71,707	71,707
- on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
- on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Hong Kong Accounting Standard 40

Investment Property



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Accounting Standard 40 *Investment Property* (HKAS 40) is set out in paragraphs 1-86. All the paragraphs have equal authority. HKAS 40 should be read in the context of its objective and the IASB's Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 40

Investment Property

Objective

- 1 The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

Scope

- 2 **This Standard shall be applied in the recognition, measurement and disclosure of investment property.**
- 3 Among other things, this Standard applies to the measurement in a lessee's financial statements of investment property interests held under a lease accounted for as a finance lease and to the measurement in a lessor's financial statements of investment property provided to a lessee under an operating lease. This Standard does not deal with matters covered in HKAS 17 *Leases*, including:
 - (a) classification of leases as finance leases or operating leases;
 - (b) recognition of lease income from investment property (see also HKFRS 15 *Revenue from Contracts with Customers* ~~HKAS 18 *Revenue*~~);
 - (c) measurement in a lessee's financial statements of property interests held under a lease accounted for as an operating lease;
 - (d) measurement in a lessor's financial statements of its net investment in a finance lease;
 - (e) accounting for sale and leaseback transactions; and
 - (f) disclosure about finance leases and operating leases.
- 4 This Standard does not apply to:
 - (a) biological assets related to agricultural activity (see HKAS 41 *Agriculture* and HKAS 16 *Property, Plant and Equipment*); and
 - (b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Definitions

- 5 The following terms are used in this Standard with the meanings specified:

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other HKFRSs, eg HKFRS 2 *Share-based Payment*.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13 *Fair Value Measurement*).

Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

 - (a) use in the production or supply of goods or services or for administrative purposes; or

- (b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Classification of property as investment property or owner-occupied property

- 6 A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33-55 for the asset recognised. This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the disclosures required by paragraphs 74-78.
- 7 Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. HKAS 16 applies to owner-occupied property.
- 8 The following are examples of investment property:
- (a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
 - (b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
 - (c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
 - (d) a building that is vacant but is held to be leased out under one or more operating leases.
 - (e) property that is being constructed or developed for future use as investment property.
- 9 The following are examples of items that are not investment property and are therefore outside the scope of this Standard:
- (a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see HKAS 2 *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
 - (b) ~~property being constructed or developed on behalf of third parties (see HKAS 11 *Construction Contracts*).~~
 - (c) owner-occupied property (see HKAS 16), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.
 - (d) ~~property that is held for sale in the ordinary course of business.~~
 - (e) property that is leased to another entity under a finance lease.

- 29 The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If the entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Measurement after recognition

Accounting policy

- 30 **With the exceptions noted in paragraphs 32A and 34, an entity shall choose as its accounting policy either the fair value model in paragraphs 33-55 or the cost model in paragraph 56 and shall apply that policy to all of its investment property.**
- 31 HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a voluntary change in accounting policy shall be made only if 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. It is highly unlikely that a change from the fair value model to the cost model will result in a more relevant presentation.
- 32 This Standard requires all entities to measure the fair value of investment property, for the purpose of either measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model). An entity is encouraged, but not required, to measure the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.
- 32A **An entity may:**
- (a) **choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and**
 - (b) **choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).**
- 32B Some insurers and other entities operate an internal property fund that issues notional units, with some units held by investors in linked contracts and others held by the entity. Paragraph 32A does not permit an entity to measure the property held by the fund partly at cost and partly at fair value.
- 32C If an entity chooses different models for the two categories described in paragraph 32A, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in profit or loss. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

Fair value model

- 33 **After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except in the cases described in paragraph 53.**
- 34 **When a property interest held by a lessee under an operating lease is classified as an investment property under paragraph 6, paragraph 30 is not elective; the fair value model shall be applied.**

Transfers

- 57 **~~Transfers~~**An entity shall transfer a property to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by: A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:
- (a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;
 - (b) commencement of development with a view to sale, for a transfer from investment property to inventories;
 - (c) end of owner-occupation, for a transfer from owner-occupied property to investment property; ~~or and~~
 - (d) ~~commencement~~inception of an operating lease to another party, for a transfer from inventories to investment property.
 - (e) [deleted]
- 58 ~~Paragraph 57(b) requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the statement of financial position) and does not reclassify treat it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.~~
- 59 Paragraphs 60-65 apply to recognition and measurement issues that arise when an entity uses the fair value model for investment property. When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.
- 60 **For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's deemed cost for subsequent accounting in accordance with HKAS 16 or HKAS 2 shall be its fair value at the date of change in use.**
- 61 **If an owner-occupied property becomes an investment property that will be carried at fair value, an entity shall apply HKAS 16 up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with HKAS 16 and its fair value in the same way as a revaluation in accordance with HKAS 16.**
- 62 Up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity depreciates the property and recognises any impairment losses that have occurred. The entity treats any difference at that date between the carrying amount of the property in accordance with HKAS 16 and its fair value in the same way as a revaluation in accordance with HKAS 16. In other words:
- (a) any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.
 - (b) any resulting increase in the carrying amount is treated as follows:
 - (i) to the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.

- (ii) any remaining part of the increase is recognised in other comprehensive income and increases the revaluation surplus within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

- 63 For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.**
- 64 The treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories.
- 65 When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.**

Disposals

- 66 An investment property shall be derecognised (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.**
- 67 The disposal of an investment property may be achieved by sale or by entering into a finance lease. ~~In determining the date of disposal for investment property is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in HKFRS 15, an entity applies the criteria in HKAS 18 for recognising revenue from the sale of goods and considers the related guidance in the Appendix to HKAS 18. HKAS 17 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.~~
- 68 If, in accordance with the recognition principle in paragraph 16, an entity recognises in the carrying amount of an asset the cost of a replacement for part of an investment property, it derecognises the carrying amount of the replaced part. For investment property accounted for using the cost model, a replaced part may not be a part that was depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Under the fair value model, the fair value of the investment property may already reflect that the part to be replaced has lost its value. In other cases it may be difficult to discern how much fair value should be reduced for the part being replaced. An alternative to reducing fair value for the replaced part, when it is not practical to do so, is to include the cost of the replacement in the carrying amount of the asset and then to reassess the fair value, as would be required for additions not involving replacement.
- 69 Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless HKAS 17 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.**
- 70 ~~The amount of consideration receivable on disposal to be included in the gain or loss arising from the derecognition of an investment property is determined in accordance with the requirements for determining the transaction price in paragraphs 47-72 of HKFRS 15. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in HKFRS 15, recognised initially at fair value. In particular, if payment for an investment property is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 using the effective interest method.~~
- 71 An entity applies HKAS 37 or other Standards, as appropriate, to any liabilities that it retains after disposal of an investment property.
- 72 Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.**

Business Combinations

- 84A *Annual Improvements Cycle 2011–2013* issued in January 2014 added paragraph 14A and a heading before paragraph 6. An entity shall apply that amendment prospectively for acquisitions of investment property from the beginning of the first period for which it adopts that amendment. Consequently, accounting for acquisitions of investment property in prior periods shall not be adjusted. However, an entity may choose to apply the amendment to individual acquisitions of investment property that occurred prior to the beginning of the first annual period occurring on or after the effective date if, and only if, information needed to apply the amendment to those earlier transactions is available to the entity.

84B *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

Transfers of investment property

84C *Transfers of Investment Property* (Amendments to HKAS 40), issued in April 2017, amended paragraphs 57–58. An entity shall apply those amendments to changes in use that occur on or after the beginning of the annual reporting period in which the entity first applies the amendments (the date of initial application). At the date of initial application, an entity shall reassess the classification of property held at that date and, if applicable, reclassify property applying paragraphs 7–14 to reflect the conditions that exist at that date.

84D Notwithstanding the requirements in paragraph 84C, an entity is permitted to apply the amendments to paragraphs 57–58 retrospectively in accordance with HKAS 8 if, and only if, that is possible without the use of hindsight.

84E If, in accordance with paragraph 84C, an entity reclassifies property at the date of initial application, the entity shall:

- (a) account for the reclassification applying the requirements in paragraphs 59–64. In applying paragraphs 59–64, an entity shall:
 - (i) read any reference to the date of change in use as the date of initial application; and
 - (ii) recognise any amount that, in accordance with paragraphs 59–64, would have been recognised in profit or loss as an adjustment to the opening balance of retained earnings at the date of initial application.
- (b) disclose the amounts reclassified to, or from, investment property in accordance with paragraph 84C. The entity shall disclose those amounts reclassified as part of the reconciliation of the carrying amount of investment property at the beginning and end of the period as required by paragraphs 76 and 79.

Effective date

- 85 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.
- 85a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).
- 85A HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 62. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

- 85B Paragraphs 8, 9, 48, 53, 54 and 57 were amended, paragraph 22 was deleted and paragraphs 53A and 53B were added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2009. An entity is permitted to apply the amendments to investment property under construction from any date before 1 January 2009 provided that the fair values of investment properties under construction were measured at those dates. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and at the same time apply the amendments to paragraphs 5 and 81E of HKAS 16 *Property, Plant and Equipment*.
- 85C HKFRS 13, issued in June 2011, amended the definition of fair value in paragraph 5, amended paragraphs 26, 29, 32, 40, 48, 53, 53B, 78-80 and 85B and deleted paragraphs 36-39, 42-47, 49, 51 and 75(d). An entity shall apply those amendments when it applies HKFRS 13.
- 85D *Annual Improvements Cycle 2011–2013* issued in January 2014 added headings before paragraph 6 and after paragraph 84 and added paragraphs 14A and 84A. An entity shall apply those amendments for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.
- 85E HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 3(b), 9, 67 and 70. An entity shall apply those amendments when it applies HKFRS 15.
- 85F [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]
- 85G *Transfers of Investment Property (Amendments to HKAS 40)*, issued in April 2017, amended paragraphs 57–58 and added paragraphs 84C–84E. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Withdrawal of SSAP 13

- 86 This Standard supersedes SSAP 13 Accounting for Investment Properties (revised in 2000).

is allowed, but not required, to classify that property interest as investment property (provided the rest of the definition of investment property is met). The Board confirmed that this classification alternative is available on a property-by-property basis.

- BC7 When a lessee's interest in property held under an operating lease is accounted for as an investment property, the Board decided that the initial carrying amounts of that interest and the related liability are to be accounted for as if the lease were a finance lease. This decision places such leases in the same position as investment properties held under finance leases in accordance with the previous version of IAS 40.
- BC8 In doing so, the Board acknowledged that this results in different measurement bases for the lease asset and the lease liability. This is also true for owned investment properties and debt that finances them. However, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*^α, as revised in 2003, an entity can elect to measure such debt at fair value, but lease liabilities cannot be remeasured in accordance with IAS 17.
- BC9 The Board considered changing the scope of IAS 39, but concluded that this would lead to a fundamental review of lease accounting, especially in relation to contingent rentals. The Board decided that this was beyond the limited revisions to IAS 40 to facilitate application of the fair value model to some operating leases classified as investment properties. The Board did, however, indicate that it wished to revisit this issue in a later project on lease accounting. The Board also noted that this was the view of the Board of the former IASC as expressed in its Basis for Conclusions, in paragraphs B25 and B26.^{*}
- BC10 Finally, the Board noted that the methodology described in paragraphs 40 and 50(d) of IAS 40, whereby a fair valuation of the property that takes all lease obligations into account is adjusted by adding back any liability that is recognised for these obligations, would, in practice, enable entities to ensure that net assets in respect of the leased interest are not affected by the use of different measurement bases.[†]

The choice between the cost model and the fair value model

- BC11 The Board also discussed whether to remove the choice in IAS 40 of accounting for investment property using a fair value model or a cost model.
- BC12 The Board noted that IASC had included a choice for two main reasons. The first was to give preparers and users time to gain experience with using a fair value model. The second was to allow time for countries with less-developed property markets and valuation professions to mature. The Board decided that more time is needed for these events to take place (IAS 40 became mandatory only for periods beginning on or after 1 January 2001). The Board also noted that requiring the fair value model would not converge with the treatment required by most of its liaison standard-setters. For these reasons, the Board decided not to eliminate the choice as part of the Improvements project, but rather to keep the matter under review with a view to reconsidering the option to use the cost model at a later date.
- BC13 The Board did not reconsider IAS 40 in relation to the accounting by lessors. The definition of investment property requires that such a property is held by the owner or a lessee under a finance lease. As indicated above, the Board agreed to allow a lessee under an operating lease, in specified circumstances, also to be a 'holder'. However, a lessor that has provided a property to a lessee under a finance lease cannot be a 'holder'. Such a lessor has a lease receivable, not an investment property.
- BC14 The Board did not change the requirements for a lessor that leases property under an operating lease that is classified and accounted for by the lessee as investment property. The Board acknowledged that this would mean that two parties could both account as if they "hold" interests in the property. This could occur at various levels of lessees who become lessors in a manner consistent with the definition of an investment property and the election provided for operating leases. Lessees who use the property in the production or supply of goods or services or for administrative purposes would not be able to classify that property as an investment property.

^α IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

^{*} These paragraphs in the IASC Basis are no longer relevant and have been deleted.

[†] Subsequently, the Board concluded that the drafting of paragraph 50 (d) was misleading because it implied that the fair value of an investment property asset held under a lease was equal to the net fair value plus the carrying amount of any recognised lease liability. Therefore, in *Improvements to IFRSs* issued in May 2008 the Board amended paragraph 50 (d) to clarify the intended meaning.

Scope

Investment property under construction

- BC15 In response to requests for guidance, the Board revisited the exclusion of investment property under construction from the scope of IAS 40. The Board noted that investment property being redeveloped remained in the scope of ~~this~~ the Standard and that the exclusion of investment property under construction gave rise to a perceived inconsistency. In addition, the Board concluded that with increasing experience with the use of fair value measures since the Standard was issued, entities were more able to measure reliably the fair value of investment property under construction. Therefore, in the exposure draft of proposed Improvements to International Financial Reporting Standards published in 2007 the Board proposed amending the scope of the Standard to include investment property under construction.
- BC16 Many respondents supported the Board's proposal. However, many expressed concern that including in IAS 40 investment property under construction might result in fewer entities measuring investment property at fair value. This was because the fair value model in the Standard requires an entity to establish whether fair value can be determined reliably when a property first becomes an investment property. If not, the property is accounted for using the cost model until it is disposed of. In some situations, the fair value of investment property under construction cannot be measured reliably but the fair value of the completed investment property can. In these cases, including in the Standard investment property under construction would have required the properties to be accounted for using the cost model even after construction had been completed.
- BC17 Therefore, the Board concluded that, in addition to including investment property under construction within the scope of the Standard, it would also amend the Standard to allow investment property under construction to be measured at cost if fair value cannot be measured reliably until such time as the fair value becomes reliably measurable or construction is completed (whichever comes earlier).

Classification of property as investment property or owner-occupied property

Acquisition of investment property: interrelationship with IFRS 3

- BC18 The IFRS Interpretations Committee (the 'Interpretations Committee') reported to the Board that practice differed in delineating the scope of IFRS 3 *Business Combinations* and IAS 40:
- (a) some considered both Standards as mutually exclusive if investment property with associated insignificant ancillary services, as specified in paragraph 11 of IAS 40, is acquired. They view property, together with any associated insignificant ancillary services, as being a single 'unit of account' and they consider this unit of account to be one asset called 'investment property'.
 - (b) others did not view IFRS 3 and IAS 40 as being mutually exclusive if investment property with associated insignificant ancillary services, as specified in paragraph 11 of IAS 40, is acquired; nor did they view the definitions of a business as defined in Appendix A of IFRS 3 and investment property as defined in paragraph 5 of IAS 40 as being interrelated. They think that an entity that acquires investment property has to determine whether it meets both definitions.
- BC19 The Board noted that paragraphs 7–14 of IAS 40 have been developed to differentiate investment property from owner-occupied property and to define the scope of IAS 40 to distinguish it from the scope of IAS 16 *Property, Plant and Equipment*. In addition, neither IFRS 3 nor IAS 40 contains a limitation in its scope that restricts its application when the other Standard applies, ie there is nothing within the scope of each Standard to suggest that they are mutually exclusive. The Board also noted that the wording of IAS 40 is not sufficiently clear about the interrelationship between the two Standards.

- BC20 The Board agreed with the proponents of the view presented in paragraph BC18(b) that IFRS 3 and IAS 40 are not mutually exclusive. It amended IAS 40 to state explicitly that judgement is also needed to determine whether the transaction is the acquisition of an asset or a group of assets or is a business combination within the scope of IFRS 3. That judgement is not based on paragraphs 7–14 of IAS 40 but is instead based on the guidance in IFRS 3. Only the judgement needed to distinguish investment property from owner-occupied property is based on those paragraphs.
- BC21 Consequently, the Board clarified the interrelationship between the two Standards by adding paragraph 14A and a heading before paragraph 6 to IAS 40.

Effective date and transition

- BC22 *Annual Improvements Cycle 2011–2013* issued in December 2013 added headings before paragraph 6 and after paragraph 84 and added paragraphs 14A, 84A and 85D to clarify the interrelationship between IFRS 3 and IAS 40. It considered the provisions for transition and the effective date of the amendment to IAS 40. The Board noted that applying IFRS 3 to transactions that have previously been accounted for as the acquisition of an asset or a group of assets might involve the use of hindsight when determining the fair values, at acquisition date, of the identifiable assets acquired and of the liabilities assumed as part of the business combination transaction. However, it also noted that the amendment is only a clarification of the interrelationship between IFRS 3 and IAS 40. Consequently, it decided that an entity would apply the amendments to IAS 40 prospectively for annual periods beginning on or after 1 July 2014, but an entity may choose to apply the amendment to individual transactions that occurred prior to the beginning of the first annual period occurring on or after the effective date only if the information needed is available to the entity.

Transfers of investment property

- BC23 The Board received a question regarding the application of paragraph 57, which specifies requirements on transfers to, or from, investment property. The question asked whether an entity transfers property under construction or development previously classified as inventory to investment property when there is evidence of a change in use, even if that evidence is not specifically listed in paragraph 57(a)–(d).
- BC24 Paragraph 57 requires transfers to, or from, investment property when, and only when, there is a change in use of property supported by evidence. The Board noted that the words ‘when, and only when’ in this paragraph are important to ensure that a transfer is limited to situations in which a change in use has occurred. The Board observed that the list of circumstances that provide evidence of a change in use specified in paragraph 57(a)–(d) of IAS 40 was drafted such that it was exhaustive (as shown by the references to ‘when and only when’ and ‘evidenced by’ in that paragraph).
- BC25 The Board decided, however, to amend paragraph 57 so that it reflects the principle that a change in use would involve (a) an assessment of whether a property meets, or has ceased to meet, the definition of investment property; and (b) supporting evidence that a change in use has occurred. Applying this principle, an entity transfers property under construction or development to, or from, investment property when, and only when, there is a change in the use of such property, supported by evidence.
- BC26 The Board also re-characterised the list of circumstances in paragraph 57(a)–(d) as a non-exhaustive list of examples to be consistent with the principle described in paragraph BC25.
- BC27 Respondents to the Board’s proposals asked whether management’s intended use of a property would provide sufficient evidence of a change in use of a property under construction or development. The Board decided to confirm in paragraph 57 that, in isolation, a change in management’s intentions would not be enough to support a transfer of property. This is because management’s intentions, alone, do not provide evidence of a change in use—an entity must have taken observable actions to support such a change.
- BC28 Some other respondents asked the Board to explain what provides substantive evidence of a change in use. The Board decided that such explanation is not needed. An entity assesses the specific facts and circumstances when applying paragraph 57, and paragraph 14 notes that judgement is needed to determine whether a property qualifies as investment property.

BC29 Respondents agreed with the Board's decision to re-characterise the list of circumstances in paragraph 57(a)–(d). However, some respondents were concerned that this list appeared to apply only to completed properties and, thus, they suggested that the Board add examples for a change in use of properties under construction or development. In response, the Board decided to amend paragraph 57(a) (ie to include 'commencement of development with a view to owner-occupation') and paragraph 57(d) (ie to refer to 'inception' of an operating lease, because at this point the construction of the related property might not be complete).

Transition

BC30 The Board proposed that an entity apply the amendments retrospectively. However, some respondents disagreed. They said that retrospective application might be impossible for some entities without the use of hindsight, or could be complex and burdensome in some situations—for example, in determining the exact point at which there was evidence of a change in use in prior periods, or in obtaining fair values at transfer dates in the past. Those respondents suggested either prospective application or, alternatively, retrospective application with some practical expedients.

BC31 In considering the comments, the Board observed the following:

- (a) the amounts recognised on the date of initial application would be unaffected by the transition approach for some previous changes in use, for example, transfers between investment property and owner-occupied property for entities that use the cost model.
- (b) applying the amendments retrospectively could be complex or may require the use of hindsight for some previous changes in use, for example, transfers from investment property measured using the fair value model to owner-occupied property that occurred some considerable time ago.
- (c) a prospective approach would require entities to apply the amendments only to changes in use that occur on or after the date of initial application. Such an approach might prevent an entity from reclassifying some property to reflect the conditions that exist on the date of initial application.

BC32 To address the concerns raised, the Board developed the transition method in paragraph 84C to ease the burden of applying the amendments retrospectively and to ensure that, on transition, an entity classifies property consistently with the amended Standard. If an entity uses this transition method, the Board decided to require specific disclosure of any reclassification of property at the date of initial application as part of the reconciliation of the carrying amount of investment property that is already required to be provided. This disclosure informs users of financial statements about changes to the carrying amount of investment property at the date of transition that do not reflect an underlying change in use of the property at that date.

BC33 The Board also noted that, depending on the properties held and previous changes in use that occurred, an entity may be able to apply the amendments retrospectively without the use of hindsight. If that is the case, the Board decided that the entity should not be prevented from doing so.

Basis for Conclusions on IAS 40 (2000) *Investment Property*

This Basis for Conclusions accompanies, but is not part of, IAS 40. It was issued by the Board of the former International Accounting Standards Committee (IASC) in 2000. Apart from the deletion of paragraphs B10-B20, B25 and B26, this Basis has not been revised by the IASB—those paragraphs are no longer relevant and have been deleted to avoid the risk that they might be read out of context. However, cross-references to paragraphs in IAS 40 as issued in 2000 have been marked to show the corresponding paragraphs in IAS 40 as revised by the IASB in 2003 (superseded references are struck through and new references are underlined). Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ. In addition, the text has been annotated where references to material in other standards are no longer valid, following the revision of those standards. Reference should be made to the IASB's Basis for Conclusions on the amendments made in 2003.

Background

- B1 The IASC Board (the “Board”) approved IAS 25 *Accounting for Investments* in 1986. In 1994, the Board approved a reformatted version of IAS 25 presented in the revised format adopted for International Accounting Standards from 1991. Certain terminology was also changed at that time to bring it into line with then current IASC practice. No substantive changes were made to the original approved text.
- B2 IAS 25 was one of the standards that the Board identified for possible revision in E32 *Comparability of Financial Statements*. Following comments on the proposals in E32, the Board decided to defer consideration of IAS 25, pending further work on Financial Instruments. In 1998, the Board approved IAS 38 *Intangible Assets* and IAS 39 *Financial Instruments: Recognition and Measurement*,^{*} leaving IAS 25 to cover investments in real estate, commodities and tangible assets such as vintage cars and other collectors' items.
- B3 In July 1999, the Board approved E64 *Investment Property*, with a comment deadline of 31 October 1999. The Board received 121 comment letters on E64. Comment letters came from various international organisations, as well as from 28 individual countries. The Board approved IAS 40 *Investment Property* in March 2000. Paragraph B67 below summarises the changes that the Board made to E64 in finalising IAS 40.
- B4 IAS 40 permits entities to choose between a fair value model and a cost model. As explained in paragraphs B47-B48 below, the Board believes that it is impracticable, at this stage, to require a fair value model for all investment property. At the same time, the Board believes that it is desirable to permit a fair value model. This evolutionary step forward will allow preparers and users to gain greater experience working with a fair value model and will allow time for certain property markets to achieve greater maturity.

Need for a Separate Standard

- B5 Some commentators argued that investment property should fall within the scope of IAS 16 *Property, Plant and Equipment*, and that there is no reason to have a separate standard on investment property. They believe that:
 - (a) it is not possible to distinguish investment property rigorously from owner-occupied property covered by IAS 16 and without reference to management intent. Thus, a distinction between investment property and owner-occupied property will lead to a free choice of different accounting treatments in some cases; and
 - (b) the fair value accounting model proposed in E64 is not appropriate, on the grounds that fair value is not relevant and, in some cases, not reliable in the case of investment property. The accounting treatments in IAS 16 are appropriate not only for owner-occupied property, but also for investment property.
- B6 Having reviewed the comment letters, the Board still believes that the characteristics of investment property differ sufficiently from the characteristics of owner-occupied property that there is a need for a separate Standard on investment property. In particular, the Board believes that information about the fair value of investment property, and about changes in its fair value, is highly relevant to users of financial statements. The Board believes that it is important to permit a fair value model for investment property, so that entities can report fair value information prominently. The Board tried to maintain consistency with IAS 16, except for differences dictated by the choice of a different accounting model.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

- B35 Some commentators suggested that the definition of investment property should exclude property held for rentals, but not for capital appreciation. In their view, a fair value model may be appropriate for dealing activities, but is inappropriate where an entity has historically held rental property for many years and has no intention of selling it in the foreseeable future. They consider that holding property for long-term rental is a service activity and the assets used in that activity should be treated in the same way as assets used to support other service activities. In their view, holding an investment in property in such cases is similar to holding “held-to-maturity investments”, which are measured at amortised cost under IAS 39.^v
- B36 In the Board’s view, the fair value model provides useful information about property held for rental, even if there is no immediate intention to sell the property. The economic performance of a property can be regarded as being made up of both rental income earned during the period (net of expenses) and changes in the value of future net rental income. The fair value of an investment property can be regarded as a market-based representation of the value of the future net rental income, regardless of whether the entity is likely to sell the property in the near future. Also, the Standard notes that fair value is determined without deducting costs of disposal—in other words, the use of the fair value model is not intended as a representation that a sale could, or should, be made in the near future.[#]
- B37 The classification of hotels and similar property was controversial throughout the project and commentators on E64 had mixed views on this subject. Some see hotels essentially as investments, while others see them essentially as operating properties. Some requested a detailed rule to specify whether hotels (and, perhaps, other categories of property, such as restaurants, bars and nursing homes) should be classified as investment property or as owner-occupied property.
- B38 The Board concluded that it is preferable to distinguish investment property from owner-occupied property on the basis of general principles, rather than have arbitrary rules for specific classes of property. Also, it would inevitably be difficult to establish rigorous definitions of specific classes of property to be covered by such rules. Paragraphs 11-13 of the Standard discuss cases such as hotels in the context of the general principles that apply when an entity provides ancillary services.
- B39 Some commentators requested quantitative guidance (such as a percentage) to clarify whether an “insignificant portion” is owner-occupied (paragraph 10) and whether ancillary services are “significant” (paragraphs 11-13 of the Standard). As for similar cases in other Standards, the Board concluded that quantitative guidance would create arbitrary distinctions.

Subsequent Expenditure

- B40 Some believe that there is no need to capitalise subsequent expenditure in a fair value model and that all subsequent expenditure should be recognised as an expense. However, others believe – and the Board agreed – that the failure to capitalise subsequent expenditure would lead to a distortion of the reported components of financial performance. Therefore, the Standard requires that an entity should determine whether subsequent expenditure should be capitalised using a test similar to the test used for owner-occupied property in IAS 16.
- B41 Some commentators suggested that the test for capitalising subsequent expenditure should not refer to the originally assessed standard of performance. They felt that it is impractical and irrelevant to judge against the originally assessed standard of performance, which may relate to many years in the past. Instead, they suggested that subsequent expenditure should be capitalised if it enhances the previously assessed standard of performance – for example, if it increases the current market value of the property or is intended to maintain its competitiveness in the market. The Board saw some merit in this suggestion.
- B42 Nevertheless, the Board believes that a reference to the previously assessed standard of performance would require substantial additional guidance, might not change the way the Standard is applied in practice and might cause confusion. The Board also concluded that it was important to retain the existing reference to the originally assessed standard of performance^{*} to be consistent with IAS 16 and IAS 38.

^v IFRS 9 *Financial Instruments* eliminated the held-to-maturity category. This paragraph discusses matters relevant when IAS 40 was issued.

[#] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

^{*} IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 requires all subsequent costs to be covered by its general recognition principle and eliminated the requirement to reference the originally assessed standard of performance. IAS 40 was amended as a consequence of the change to IAS 16.

Subsequent Measurement

Accounting Model

- B43 Under IAS 25, an entity was permitted to choose from among a variety of accounting treatments for investment property (depreciated cost under the benchmark treatment in IAS 16 *Property, Plant and Equipment*, revaluation with depreciation under the allowed alternative treatment in IAS 16, cost less impairment under IAS 25 or revaluation under IAS 25).[†]
- B44 E64 proposed that all investment property should be measured at fair value. Supporters of the fair value model believe that fair values give users of financial statements more useful information than other measures, such as depreciated cost. In their view, rental income and changes in fair value are inextricably linked as integral components of the financial performance of an investment property and measurement at fair value is necessary if that financial performance is to be reported in a meaningful way.
- B45 Supporters of the fair value model also note that an investment property generates cash flows largely independently of the other assets held by an entity. In their view, the generation of independent cash flows through rental or capital appreciation distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not merely to property, but also to other assets used in the production or supply process. Proponents of the fair value model for investment property argue that this distinction makes a fair value model more appropriate for investment property than for owner-occupied property.
- B46 Those who oppose measurement of investment property at fair value argue that:
- (a) there is often no active market for investment property (unlike for many financial instruments). Real estate transactions are not frequent and not homogeneous. Each investment property is unique and each sale is subject to significant negotiations. As a result, fair value measurement will not enhance comparability because fair values are not determinable on a reliable basis, especially in countries where the valuation profession is less well established. A depreciated cost measurement provides a more consistent, less volatile, and less subjective measurement;
 - (b) IAS 39^{*} does not require fair value measurement for all financial assets, even some that are realised more easily than investment property. It would be premature to consider extending the fair value model until the Joint Working Group on financial instruments has completed its work;
 - (c) a cost basis is used for “shorter term” assets (such as inventories) for which fair value is, arguably, more relevant than for “held for investment” assets; and
 - (d) measurement at fair value is too costly in relation to the benefits to users.
- B47 This is the first time that the Board has proposed requiring a fair value accounting model for non-financial assets. The comment letters on E64 showed that although many support this step, many others still have significant conceptual and practical reservations about extending a fair value model to non-financial assets, particularly (but not exclusively) for entities whose main activity is not to hold property for capital appreciation. Also, some entities feel that certain property markets are not yet sufficiently mature for a fair value model to work satisfactorily. Furthermore, some believe that it is impossible to create a rigorous definition of investment property and that this makes it impracticable to require a fair value model at present.
- B48 For those reasons, the Board believes that it is impracticable, at this stage, to require a fair value model for investment property. At the same time, the Board believes that it is desirable to permit a fair value model. This evolutionary step forward will allow preparers and users to gain greater experience working with a fair value model and will allow time for certain property markets to achieve greater maturity.
- B49 IAS 40 permits entities to choose between a fair value model and a cost model. An entity should apply the model chosen to all its investment property. [This choice is not available to a lessee accounting for an investment property under an operating lease as if it were a finance

[†] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to ‘benchmark’ treatment and ‘allowed alternative’ treatments. They are replaced with cost model and revaluation model.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

lease—refer to the IASB's Basis for Conclusions on the amendments made in 2003.] The fair value model is the model proposed in E64: investment property should be measured at fair value and changes in fair value should be recognised in the income statement. The cost model is the benchmark treatment^{*} in IAS 16 *Property, Plant and Equipment*: investment property should be measured at depreciated cost (less any accumulated impairment losses). An entity that chooses the cost model should disclose the fair value of its investment property.

- B50 Under IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*,[†] a change in accounting policies from one model to the other model should be made only if the change will result in a more appropriate presentation of events or transactions.[‡] The Board concluded that this is highly unlikely to be the case for a change from the fair value model to the cost model and paragraph 25 31 of the Standard reflects this conclusion.
- B51 The Board believes that it is undesirable to permit three different accounting treatments for investment property. Accordingly, if an entity does not adopt the fair value model, the Standard requires the entity to use the benchmark treatment in IAS 16 and does not permit the use of the allowed alternative treatment. However, an entity may still use the allowed alternative for other properties covered by IAS 16.[⊕]

Guidance on Fair Value[#]

- B52 The valuation profession will have an important role in implementing the Standard. Accordingly, in developing its guidance on the fair value of investment property, the Board considered not only similar guidance in other IASC literature, but also International Valuation Standards (IVS) issued by the International Valuation Standards Committee (IVSC). The Board understands that IVSC intends to review, and perhaps revise, its Standards in the near future.
- B53 The Board believes that IASC's concept of fair value is similar to the IVSC concept of market value. IVSC defines market value as "the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion." The Board believes that the guidance in paragraphs ~~29-30~~ 36, 37 and ~~32-38~~ 39-44 of the Standard is, in substance (and largely in wording as well), identical with guidance in IVS 1.^β
- B54 Paragraphs ~~31~~ 38 and ~~39-46~~ 45-52 of IAS 40 have no direct counterpart in the IVSC literature. The Board developed much of this material in response to commentators on E64, who asked for more detailed guidance on determining the fair value of investment property. In developing this material, the Board considered guidance on fair value in other IASC Standards and Exposure Drafts, particularly those on financial instruments (IAS 32 and IAS 39^α), intangible assets (IAS 38) and agriculture (E65).^Ω

Independent Valuation

- B55 Some commentators believe that fair values should be determined on the basis of an independent valuation, to enhance the reliability of the fair values reported. Others believe, on cost-benefit grounds, that IASC should not require (and perhaps not even encourage) an independent valuation. They believe that it is for preparers to decide, in consultation with auditors, whether an entity has sufficient internal resources to determine reliable fair values. Some also believe that independent valuers with appropriate expertise are not available in some markets.

^{*} IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

[†] revised by the IASB in 2003 as IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

[‡] The IASB conformed the terminology used in paragraph 31 to the terminology used in IAS 8 by *Improvements to IFRSs* issued in May 2008.

[⊕] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

[#] IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

^β The requirements for measuring fair value in IFRS 13, issued in May 2011, differ in some respects from the guidance for measuring market value in accordance with IVS 1. IFRS 13 deleted paragraphs 36, 37 and 42-44 of IAS 40.

^α IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

^Ω IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value. As a consequence paragraphs 38, 45-47, 49 and 51 of IAS 40 have been deleted.

Gains and Losses on Remeasurement to Fair Value

- B63 Some commentators argued that there should be either a requirement or an option to recognise changes in the fair value of investment property in equity, on the grounds that:
- (a) the market for property is not liquid enough and market values are uncertain and variable. Investment property is not as liquid as financial instruments and IAS 39 allows an option for available-for-sale investments;[∇]
 - (b) until performance reporting issues are resolved more generally, it is premature to require recognition of fair value changes in the income statement;
 - (c) recognition of unrealised gains and losses in the income statement increases volatility and does not enhance transparency, because revaluation changes will blur the assessment of an entity's operating performance. It may also cause a presumption that the unrealised gains are available for distribution as dividends;
 - (d) recognition in equity is more consistent with the historical cost and modified historical cost conventions that are a basis for much of today's accounting. For example, it is consistent with IASC's treatment of revaluations of property, plant and equipment under IAS 16 and with the option available for certain financial instruments under IAS 39;^β
 - (e) for properties financed by debt, changes in the fair value of the properties resulting from interest rate changes should not be recognised in the income statement, since the corresponding changes in the fair value of the debt are not recognised under IAS 39;
 - (f) under paragraphs 92 and 93 of the *Framework*,[#] income should be recognised only when it can be measured with sufficient certainty. For example, IAS 11 *Construction Contracts*^α requires certain conditions before an entity can use the percentage-of-completion method. These conditions are not normally met for investment property; and
 - (g) results from operations should be distinguished from changes in values. For example, under IAS 21, unrealised exchange differences on a foreign entity[†] are recognised in equity.
- B64 Some commentators suggested that increases should be recognised in equity and decreases should be recognised in ~~net~~ profit or loss. This is similar to the revaluation model that forms the allowed alternative treatment[†] in IAS 16 (except for the lack of depreciation).
- B65 As proposed in E64, the Board concluded that, in a fair value model, changes in the fair value of investment property should be recognised in the income statement as part of profit or loss for the period. The arguments for this approach include the following:
- (a) the conceptual case for the fair value model is built largely on the view that this provides the most relevant and transparent view of the financial performance of investment property. Given this, it would be inconsistent to permit or require recognition in equity;
 - (b) recognition of fair value changes in equity would create a mismatch because net rental income would be recognised in the income statement, whereas the related consumption of the service potential (recognised as depreciation under IAS 16) would be recognised in equity. Similarly, maintenance expenditure would be recognised as an expense while related increases in fair value would be recognised in equity;
 - (c) using this approach, there is no need to resolve some difficult and controversial issues that would arise if changes in the fair value of investment property were recognised in equity. These issues include the following:

[∇] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

^β IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

[#] The reference to the *Framework* is to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 92 and 93 are now paragraphs 4.47 and 4.48 of the *Conceptual Framework*.

^α IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts*.

[†] In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as revised by the IASB in 2003, the term 'foreign entity' was replaced by 'foreign operation'.

[†] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

- (i) should fair value changes previously recognised in equity be transferred ("recycled") to profit or loss on disposal of investment property; and
- (ii) should fair value changes previously recognised in equity be transferred ("recycled") to profit or loss when investment property is impaired? If so, how should such impairment be identified and measured; and
- (d) given the difficulty in defining investment property rigorously, entities will sometimes have the option of applying the investment property standard or either of the two treatments in IAS 16. It would be undesirable to include two choices in the investment property standard, as this would give entities a choice (at least occasionally) between four different treatments.

Transfers

- B66 When an owner-occupied property carried under the benchmark treatment under IAS 16 becomes an investment property, the measurement basis for the property changes from depreciated cost to fair value. The Board concluded that the effect of this change in measurement basis should be treated as a revaluation under IAS 16 at the date of change in use. The result is that:
- (a) the income statement excludes cumulative net increases in fair value that arose before the property became investment property. The portion of this change that arose before the beginning of the current period does not represent financial performance of the current period; and
 - (b) this treatment creates comparability between entities that had previously revalued the property under the allowed alternative treatment in IAS 16 and those entities that had previously used the IAS 16 benchmark treatment.*

Summary of Changes to E64

- B67 The most important change between E64 and the final Standard was the introduction of the cost model as an alternative to the fair value model. The other main changes are listed below.
- (a) The guidance on determining fair value was expanded, to clarify the following:†
 - (i) the fair value of investment property is not reduced by transaction costs that may be incurred on sale or other disposal (paragraph ~~39-37~~ of the Standard). This is consistent with the measurement of financial assets under paragraph 69 of IAS 39.‡ E64 was silent on the treatment of such costs;
 - (ii) measurement is based on valuation at the balance sheet date (paragraph ~~38~~);
 - (iii) the best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts (paragraph ~~39-45~~). In the absence of such evidence, fair value reflects information from a variety of sources and an entity needs to investigate reasons for any differences between the information from different sources (paragraphs ~~40-41-46 and 47~~);
 - (iv) market value differs from value in use as defined in IAS 36 *Impairment of Assets* (paragraph ~~43-49~~);
 - (v) there is a need to avoid double counting of investment property and separately recognised assets and liabilities. Integral equipment (such as elevators or air-conditioning) is generally included in the investment property, rather than recognised separately (paragraph ~~44-50~~);
 - (vi) the fair value of investment property does not reflect future capital expenditure that will improve or enhance the asset and does not reflect the related future benefits from this future expenditure (paragraph ~~45-51~~);

* IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

† IFRS 13, issued in May 2011, contains the requirements for measuring fair value and for disclosing information about fair value measurements. As a consequence paragraphs 37, 38, 45-47, 49, 51 and 75(d) of IAS 40 have been deleted.

‡ Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. *IFRS 9 Financial Instruments* deleted paragraph 46 of IAS 39.

- (vii) an entity uses IAS 37 to account for any provisions associated with investment property (~~paragraph 46-52~~); and
 - (viii) in the exceptional cases when fair value cannot be determined reliably, measurement is under the IAS 16 benchmark treatment* only (in such cases, revaluation under IAS 16 would also not be reliable) and residual value is assumed to be zero (given that fair value cannot be determined reliably) (~~paragraphs 47-48-53 and 54~~).
- (b) In relation to the scope of the Standard and the definition of investment property:
- (i) paragraph ~~3~~ 4 now clarifies that the Standard does not apply to forests and similar regenerative natural resources and to mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources. This wording is consistent with a similar scope exclusion in IAS 16 *Property, Plant and Equipment*. The Board did not wish to prejudge its decision on the treatment of such items in the current projects on Agriculture and the Extractive Industries;
 - (ii) land held for a currently undetermined future use is a further example of investment property (~~paragraph 6(b)-8(b)~~), on the grounds that a subsequent decision to use such land as inventory or for development as owner-occupied property would be an investment decision;
 - (iii) new examples of items that are not investment property are: property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal (~~paragraph 7(e)-9(c)~~);
 - (iv) property that is being constructed or developed for future use as investment property is now covered by IAS 16 and measured at cost, less impairment losses, if any (~~paragraph 7(d)-9(d)~~). E64 proposed that investment property under construction should be measured at fair value; and
 - (v) the reference to reliable measurement of fair value (and the related requirements in paragraphs 14-15 of E64) was moved from the definition of investment property into the section on subsequent measurement (~~paragraphs 47-49-53-55~~).
- (c) New paragraph 23 deals with start up costs, initial operating losses and abnormal wastage (based on paragraphs 17 and 18 of IAS 16[†]). The Board considered adding guidance on the treatment of incidental revenue earned during the construction of investment property. However, the Board concluded that this raised an issue in the context of IAS 16 and decided that it was beyond the scope of this project to deal with this.
- (d) There is an explicit requirement on determining gains or losses on disposal (~~paragraph 62-69~~). This is consistent with IAS 16, paragraph 56.^φ There are also new cross-references to:
- (i) IAS 17 *Leases* and IAS 18 *Revenue*^α, as guidance for determining the date of disposal (~~paragraph 61-67~~); and
 - (ii) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, for liabilities retained after disposal (~~paragraph 64-71~~).
- (e) The Standard states explicitly that an entity should transfer an investment property to inventories when the entity begins to develop the property for subsequent sale in the ordinary course of business (~~paragraphs 51(b) and 52-57(b) and 58~~). E64 proposed that all transfers from investment properties to inventories should be prohibited. The Standard also deals more explicitly than E64 with certain other aspects of transfers.

* IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

† In IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003, paragraphs 17 and 18 were replaced by paragraphs 19-22.

φ In IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003, paragraph 56 was replaced by paragraphs 68 and 71.

α IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 67 of IAS 40 for consistency with the requirements in IFRS 15.

Basis for Conclusions
Hong Kong Accounting Standard 41

Agriculture



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Basis for IASC's Conclusions on IAS 41 Agriculture

This Basis for Conclusions accompanies, but is not part of, IAS 41. It was prepared by the IASC Staff in 2000 but was not approved by the IASC Board. It summarises the Board's reasons for:

- (a) *initiating and proposing an International Accounting Standard on agriculture; and*
- (b) *accepting or rejecting certain alternative views.*

Individual Board members gave greater weight to some factors than to others.

This Basis has not been revised by the IASB and the terminology has not been amended to reflect the changes made by Improvements to IFRSs issued in May 2008.

Background

- B1 In 1994, the IASC Board (the 'Board') decided to develop an International Accounting Standard on agriculture and appointed a Steering Committee to help define the issues and develop possible solutions. In 1996, the Steering Committee published a Draft Statement of Principles ('DSOP') setting out the issues, alternatives, and the Steering Committee's proposals for resolving the issues and inviting public comment. In response, 42 comment letters were received. The Steering Committee reviewed the comments, revised certain of its recommendations, and submitted them to the Board.
- B2 In July 1999, the Board approved Exposure Draft E65 *Agriculture* with a comment deadline of 31 January 2000. The Board received 62 comment letters on E65. They came from various international organisations, as well as from 28 individual countries. In April 2000, the IASC Staff sent a questionnaire to entities that undertake agricultural activity in an attempt to determine the reliability of the fair value measurement proposed in E65 and received 20 responses from 11 countries. In December 2000, after considering the comments on E65 and responses to the questionnaire, the Board approved IAS 41 *Agriculture* (the Standard). Paragraph B82 below summarises the changes that the Board made to E65 in finalising the Standard.

The need for an International Accounting Standard on agriculture

- B3 A main objective of the IASC is to develop International Accounting Standards that are relevant in the general purpose financial statements of all businesses. While most International Accounting Standards apply to entities in all activities, some International Accounting Standards, for example IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and IAS 40 *Investment Property*, deal with issues that arise in particular activities. IASC has also undertaken industry-specific projects on insurance and extractive industries.
- B4 Diversity in accounting for agricultural activity has occurred because:
- (a) prior to the development of the Standard, assets related to agricultural activity and changes in those assets were excluded from the scope of International Accounting Standards:
 - (i) IAS 2 *Inventories* excluded 'producers' inventories of livestock, agricultural and forest products... to the extent that they are measured at net realisable value in accordance with well established practices in certain industries';
 - (ii) IAS 16 *Property, Plant and Equipment* did not apply to 'forests and similar regenerative natural resources';
 - (iii) IAS 18 *Revenue*[#] did not deal with revenue arising from 'natural increases in herds, and agricultural and forest products'; and

* In August 2005, IFRS 7 *Financial Instruments: Disclosure* supersedes IAS 30.

IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 also does not address revenue arising from 'natural increases in herds, and agricultural and forest products'.

Sales contracts

- B47 Entities often enter into contracts to sell at a future date their biological assets or agricultural produce. The Standard indicates that contract prices are not necessarily relevant in determining fair value and that the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.
- B48 E65 did not propose how to account for a contract for the sale of a biological asset or agricultural produce. Some commentators suggested prescribing the treatment of sales contracts since such sales contracts are common in certain agricultural activity. Some commentators also pointed out that certain sales contracts are not within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*[#] and that no other International Accounting Standards deal with those contracts.
- B49 Some argue that contract prices should be used in measuring the related biological assets when an entity expects to settle the contract by delivery and believe this would result in the most relevant carrying amount for the biological asset. Others argue that contract prices are not necessarily relevant in measuring the biological assets at fair value since fair value reflects the current market in which a willing buyer and seller would enter into a transaction.*
- B50 The Board concluded that contract prices should not be used in measuring related biological assets, because contract prices do not necessarily reflect the current market in which a willing buyer and seller would enter into a transaction and therefore do not necessarily represent the fair value of assets. The Board wished to maintain a consistent approach to the measurement of assets. The Board instead considered whether it might require that sales contracts be measured at fair value. It is logical to measure a sales contract at fair value to the extent that a related biological asset is also measured at fair value.
- B51 However, the Board noted that to achieve symmetry between the measurement of a biological asset and a related sales contract the Standard would have to carefully restrict the sales contracts to be measured at fair value. An entity may enter into a contract to sell agricultural produce to be harvested from the entity's biological assets. The Board concluded that it would not be appropriate to require fair value measurement for a contract to sell agricultural produce that does not yet exist (for example, milk to be harvested from a cow), since no related asset has yet been recognised or measured at fair value and to do so would be beyond the scope of the project on agriculture.
- B52 Thus, the Board considered restricting the sales contracts to be measured at fair value to those for the sale of an entity's existing biological assets and agricultural produce. However, the Board noted that it is difficult to differentiate existing agricultural produce from agricultural produce that does not exist. For example:
- (a) if an entity enters into a contract to sell fully-grown wheat at a future date and has half-grown wheat at a balance sheet date, it seems clear that the wheat to be delivered under the contract does not yet exist at the balance sheet date; but
 - (b) on the other hand, if an entity enters into a contract to sell mature cattle at a future date and has mature cattle at a balance sheet date, it could be argued that the cattle exist in the form in which they will be sold at the balance sheet date. However, it could also be argued that the cattle do not yet exist in the form in which they will be sold at the balance sheet date since further biological transformation will occur between the balance sheet date and the date of delivery.
- B53 The Board also noted that the Standard would have to require an entity to stop fair value measurement for sales contracts once agricultural produce to be sold under the contract is harvested from an entity's biological assets, since accounting for agricultural produce is not dealt with in the Standard except for initial measurement and IAS 2 *Inventories* or another applicable International Accounting Standard applies after harvest. It would be illogical to continue fair value measurement when the agricultural produce is measured at historical cost. The Board noted that it would be anomalous to require an entity to start measuring a contract at fair value once the related asset exists and to stop doing that at a later date.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

* IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

- B54 The Board concluded that no solution is practicable without a complete review of the accounting for commodity contracts that are not within the scope of IAS 39.² Because of the above difficulties, the Board concluded that the Standard should not deal with the measurement of sales contracts that are not within the scope of IAS 39. Instead, the Board decided to include an observation that those sales contracts may be onerous contracts under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Land related to agricultural activity

- B55 The Standard does not establish any new principles for land related to agricultural activity. Rather, an entity follows IAS 16 *Property, Plant and Equipment*, or IAS 40 *Investment Property*, depending on which standard is appropriate in the circumstances. IAS 16 requires land to be measured either at its cost less any accumulated impairment losses, or at a revalued amount. IAS 40 requires land that is investment property to be measured at its fair value, or cost less any accumulated impairment losses.
- B56 Some argue that land attached to biological assets related to agricultural activity should also be measured at its fair value. They argue that fair value measurement of land results in consistency of measurement with the fair value measurement of biological assets. They also argue that it is sometimes difficult to measure the fair value of such biological assets separately from the land since an active market often exists for the combined assets (that is, land and biological assets; for example, trees in a plantation forest).
- B57 The Board rejected this approach, primarily because requiring the fair value measurement of land related to agricultural activity would be inconsistent with IAS 16.

Intangible assets

- B58 The Standard does not establish any new principles for intangible assets related to agricultural activity. Rather, an entity follows IAS 38 *Intangible Assets*. IAS 38 requires an intangible asset, after initial recognition, to be measured at its cost less any accumulated amortisation and impairment losses, or at a revalued amount.
- B59 E65 proposed that an entity should be encouraged to follow the revaluation alternative in IAS 38 for intangible assets related to agricultural activity, to enhance consistency of measurement with the fair value measurement of biological assets. Some commentators on E65 disagreed with having the encouragement. They argued that a unique treatment for intangible assets related to agricultural activity is not warranted.
- B60 The Board did not include the encouragement in E65 in the Standard. The Board concluded that IAS 38 should be applied to intangible assets related to agricultural activity, as it is to intangible assets related to other activities.

Subsequent expenditure

- B61 The Standard does not explicitly prescribe how to account for subsequent expenditure related to biological assets. E65 proposed that costs of producing and harvesting biological assets should be charged to expense when incurred and that costs that increase the number of units of biological assets owned or controlled by the entity should be added to the carrying amount of the asset.
- B62 Some believe that there is no need to capitalise subsequent expenditure in a fair value model and that all subsequent expenditure should be recognised as an expense. Some also argue that it would sometimes be difficult to prescribe which costs should be recognised as expenses and which costs should be capitalised; for example, in the case of vet fees paid for delivering a calf. The Board decided not to explicitly prescribe the accounting for subsequent expenditure related to biological assets in the Standard, because it believes to do so is unnecessary with a fair value measurement approach.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- B70 The Board considered two alternative approaches:
- (a) an entity should recognise a conditional government grant as income when it is probable that the entity will meet the conditions attaching to the government grant; and
 - (b) an entity should recognise a conditional government grant as income when the entity meets the conditions attaching to the government grant.
- B71 Proponents of approach (a) argue that this approach is generally consistent with the revenue recognition requirements in IAS 18 *Revenue*.^{*} IAS 18 requires that revenue should be recognised, among other things, when it is probable that the economic benefits associated with the transaction will flow to the entity.
- B72 Proponents of approach (b) believe that, until the conditions attaching to the government grant are met, a liability should be recognised under the Framework rather than income since an entity has a present obligation to satisfy the conditions arising from past events. They also argue that income recognition under approach (a) would still be subjective and inconsistent with the recognition criteria indicated in the *Framework*.
- B73 The Board concluded that approach (b) is more appropriate. The Board also decided that a government grant that requires an entity not to engage in specified agricultural activity should also be accounted for in the same way as a conditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs.

Disclosure

Separate disclosure of physical and price changes

- B74 The Standard encourages, but does not require, separate disclosure of the effects of the factors resulting in changes to the carrying amount of biological assets, physical change and price change, when there is a production cycle of more than one year. Physical change is attributable to changes in the assets themselves while price change is attributable to changes in unit fair values.
- B75 Some argue that the separate disclosure should be required since it is useful in appraising current period performance and future prospects in relation to production from, and maintenance and renewal of, biological assets. Others argue that it may be impracticable to separate these elements and the two components cannot be separated reliably.
- B76 The Board concluded that the separate disclosure should not be required because of practicability concerns. However, the Board decided to encourage the separate disclosure, given that such disclosure may be useful and practically determinable in some circumstances. The separate disclosure is not encouraged when the production cycle is less than one year (for example, when raising broiler chickens or growing cereal crops) since that information is less useful in that circumstance.
- B77 Some argue that physical changes should be included in net profit or loss and that price changes should be included directly in equity, through the statement of changes in equity. The Board rejected this approach because both components are indicative of management's performance.

Disaggregation of the gain or loss

- B78 The Standard requires that an entity should disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less estimated point-of-sale costs of biological assets. The Standard does not require or encourage disaggregating the gain or loss, except that the Standard encourages separate disclosure of physical changes and price changes as discussed above.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.

HKFRS 1 (Revised)
Revised September 2018~~January 2017~~

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 1 *First-time Adoption of Hong Kong Financial Reporting Standards* (HKFRS 1) is set out in paragraphs 1–40 and Appendices A–F. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 1 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

- IN1 The Hong Kong Institute of Certified Public Accountants (HKICPA) issued HKFRS 1 in October 2003. This HKFRS prescribes the accounting treatment that an entity shall apply when it adopts HKFRSs for the first time as the basis for preparing its financial statements and interim financial reports.
- IN2 Subsequently, HKFRS 1 was amended many times to accommodate first-time adoption requirements resulting from new or amended HKFRSs. As a result, the HKFRS became more complex and less clear. Therefore, the HKICPA revised HKFRS 1 to make it easier for the reader to understand and to design it to better accommodate future changes. The version of HKFRS 1 issued in 2008 retains the substance of the previous version, but within a changed structure. It replaces the previous version and is effective for entities applying HKFRSs for the first time for annual periods beginning on or after 1 July 2009. Earlier application is permitted.

Main features of the HKFRS

- IN3 The HKFRS applies when an entity adopts HKFRSs for the first time by an explicit and unreserved statement of compliance with HKFRSs.
- IN4 In general, the HKFRS requires an entity to comply with each HKFRS effective at the end of its first HKFRS reporting period. In particular, the HKFRS requires an entity to do the following in the opening HKFRS statement of financial position that it prepares as a starting point for its accounting under HKFRSs:
- (a) recognise all assets and liabilities whose recognition is required by HKFRSs;
 - (b) not recognise items as assets or liabilities if HKFRSs do not permit such recognition;
 - (c) reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under HKFRSs; and
 - (d) apply HKFRSs in measuring all recognised assets and liabilities.
- IN5 The HKFRS grants limited exemptions from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The HKFRS also prohibits retrospective application of HKFRSs in some areas, particularly where retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known.
- IN6 The HKFRS requires disclosures that explain how the transition from previous GAAP to HKFRSs affected the entity's reported financial position, financial performance and cash flows.
- IN7 An entity is required to apply the HKFRS if its first HKFRS financial statements are for a period beginning on or after 1 July 2009. Earlier application is encouraged.
- IN8 Paragraphs B10 and B11 (introduced by *Government Loans* in March 2012) refer to HKFRS 9. If an entity applies this HKFRS but does not yet apply HKFRS 9, the references in paragraphs B10 and B11 to HKFRS 9 shall be read as references to HKAS 39 *Financial Instruments: Recognition and Measurement*.

Hong Kong Financial Reporting Standard 1

First-time Adoption of Hong Kong Financial Reporting Standards

Objective

- 1 The objective of this HKFRS is to ensure that an entity's *first HKFRS financial statements*, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:
- (a) is transparent for users and comparable over all periods presented;
 - (b) provides a suitable starting point for accounting in accordance with *Hong Kong Financial Reporting Standards (HKFRSs)*; and
 - (c) can be generated at a cost that does not exceed the benefits.

Scope

- 2 An entity shall apply this HKFRS in:
- (a) its first HKFRS financial statements; and
 - (b) each interim financial report, if any, that it presents in accordance with HKAS 34 *Interim Financial Reporting* for part of the period covered by its first HKFRS financial statements.
- 3 An entity's first HKFRS financial statements are the first annual financial statements in which the entity adopts HKFRSs, by an explicit and unreserved statement in those financial statements of compliance with HKFRSs. Financial statements in accordance with HKFRSs are an entity's first HKFRS financial statements if, for example, the entity:
- (a) presented its most recent previous financial statements:
 - (i) in accordance with other accounting requirements that are not consistent with HKFRSs in all respects;
 - (ii) in conformity with HKFRSs in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with HKFRSs;
 - (iii) containing an explicit statement of compliance with some, but not all, HKFRSs;
 - (iv) in accordance with other accounting requirements inconsistent with HKFRSs, using some individual HKFRSs to account for items for which other accounting requirements did not exist; or
 - (v) in accordance with other accounting requirements, with a reconciliation of some amounts to the amounts determined in accordance with HKFRSs;
 - (b) prepared financial statements in accordance with HKFRSs for internal use only, without making them available to the entity's owners or any other external users;
 - (c) prepared a reporting package in accordance with HKFRSs for consolidation purposes without preparing a complete set of financial statements as defined in HKAS 1 *Presentation of Financial Statements* (as revised in 2007); or
 - (d) did not present financial statements for previous periods.

- 4 This HKFRS applies when an entity first adopts HKFRSs. It does not apply when, for example, an entity:
- (a) stops presenting financial statements in accordance with other accounting requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with HKFRSs;
 - (b) presented financial statements in the previous year in accordance with other accounting requirements and those financial statements contained an explicit and unreserved statement of compliance with HKFRSs; or
 - (c) presented financial statements in the previous year that contained an explicit and unreserved statement of compliance with HKFRSs, even if the auditors qualified their audit report on those financial statements.
- 4A Notwithstanding the requirements in paragraphs 2 and 3, an entity that has applied HKFRSs in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with HKFRSs, must either apply this HKFRS or else apply HKFRSs retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as if the entity had never stopped applying HKFRSs.
- 4B When an entity does not elect to apply this HKFRS in accordance with paragraph 4A, the entity shall nevertheless apply the disclosure requirements in paragraphs 23A-23B of HKFRS 1, in addition to the disclosure requirements in HKAS 8.
- 5 This HKFRS does not apply to changes in accounting policies made by an entity that already applies HKFRSs. Such changes are the subject of:
- (a) requirements on changes in accounting policies in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; and
 - (b) specific transitional requirements in other HKFRSs.

Recognition and measurement

Opening HKFRS statement of financial position

- 6 An entity shall prepare and present an *opening HKFRS statement of financial position* at the date of transition to HKFRSs. This is the starting point for its accounting in accordance with HKFRSs.

Accounting policies

- 7 An entity shall use the same accounting policies in its opening HKFRS statement of financial position and throughout all periods presented in its first HKFRS financial statements. Those accounting policies shall comply with each HKFRS effective at the end of its *first HKFRS reporting period*, except as specified in paragraphs 13–19 and Appendices B–E.
- 8 An entity shall not apply different versions of HKFRSs that were effective at earlier dates. An entity may apply a new HKFRS that is not yet mandatory if that HKFRS permits early application.

Example: Consistent application of latest version of HKFRSs**Background**

The end of entity A's first HKFRS reporting period is 31 December 20X5. Entity A decides to present comparative information in those financial statements for one year only (see paragraph 21). Therefore, its date of transition to HKFRSs is the beginning of business on 1 January 20X4 (or, equivalently, close of business on 31 December 20X3). Entity A presented financial statements in accordance with its *previous GAAP* annually to 31 December each year up to, and including, 31 December 20X4.

Application of requirements

Entity A is required to apply the HKFRSs effective for periods ending on 31 December 20X5 in:

- (a) preparing and presenting its opening HKFRS statement of financial position at 1 January 20X4; and
- (b) preparing and presenting its statement of financial position for 31 December 20X5 (including comparative amounts for 20X4), statement of comprehensive income, statement of changes in equity and statement of cash flows for the year to 31 December 20X5 (including comparative amounts for 20X4) and disclosures (including comparative information for 20X4).

If a new HKFRS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that HKFRS in its first HKFRS financial statements.

- 9 The transitional provisions in other HKFRSs apply to changes in accounting policies made by an entity that already uses HKFRSs; they do not apply to a *first-time adopter's* transition to HKFRSs, except as specified in Appendices B–E.
- 10 Except as described in paragraphs 13–19 and Appendices B–E, an entity shall, in its opening HKFRS statement of financial position:
 - (a) recognise all assets and liabilities whose recognition is required by HKFRSs;
 - (b) not recognise items as assets or liabilities if HKFRSs do not permit such recognition;
 - (c) reclassify items that it recognised 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 HKFRSs; and
 - (d) apply HKFRSs in measuring all recognised assets and liabilities.
- 11 The accounting policies that an entity uses in its opening HKFRS statement of financial position may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to HKFRSs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to HKFRSs.

- 12 This HKFRS establishes two categories of exceptions to the principle that an entity's opening HKFRS statement of financial position shall comply with each HKFRS:
- (a) paragraphs 14–17 and Appendix B prohibit retrospective application of some aspects of other HKFRSs.
 - (b) Appendices C–E grant exemptions from some requirements of other HKFRSs.

Exceptions to the retrospective application of other HKFRSs

- 13 This HKFRS prohibits retrospective application of some aspects of other HKFRSs. These exceptions are set out in paragraphs 14–17 and Appendix B.

Estimates

- 14 **An entity's estimates in accordance with HKFRSs at the date of transition to HKFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.**
- 15 An entity may receive information after the date of transition to HKFRSs about estimates that it had made under previous GAAP. In accordance with paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with HKAS 10 *Events after the Reporting Period*. For example, assume that an entity's date of transition to HKFRSs is 1 January 20X4 and new information on 15 July 20X4 requires the revision of an estimate made in accordance with previous GAAP at 31 December 20X3. The entity shall not reflect that new information in its opening HKFRS statement of financial position (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 December 20X4.
- 16 An entity may need to make estimates in accordance with HKFRSs at the date of transition to HKFRSs that were not required at that date under previous GAAP. To achieve consistency with HKAS 10, those estimates in accordance with HKFRSs shall reflect conditions that existed at the date of transition to HKFRSs. In particular, estimates at the date of transition to HKFRSs of market prices, interest rates or foreign exchange rates shall reflect market conditions at that date.
- 17 Paragraphs 14–16 apply to the opening HKFRS statement of financial position. They also apply to a comparative period presented in an entity's first HKFRS financial statements, in which case the references to the date of transition to HKFRSs are replaced by references to the end of that comparative period.

Exemptions from other HKFRSs

- 18 An entity may elect to use one or more of the exemptions contained in Appendices C–E. An entity shall not apply these exemptions by analogy to other items.
- 19 [Deleted]

Presentation and disclosure

- 20 This HKFRS does not provide exemptions from the presentation and disclosure requirements in other HKFRSs.

Comparative information

- 21 An entity's first HKFRS financial statements shall include at least three statements of financial position, two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information for all statements presented.

Non-HKFRS comparative information and historical summaries

- 22 Some entities present historical summaries of selected data for periods before the first period for which they present full comparative information in accordance with HKFRSs. This HKFRS does not require such summaries to comply with the recognition and measurement requirements of HKFRSs. Furthermore, some entities present comparative information in accordance with previous GAAP as well as the comparative information required by HKAS 1. In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:
- (a) label the previous GAAP information prominently as not being prepared in accordance with HKFRSs; and
 - (b) disclose the nature of the main adjustments that would make it comply with HKFRSs. An entity need not quantify those adjustments.

Explanation of transition to HKFRSs

- 23 **An entity shall explain how the transition from previous GAAP to HKFRSs affected its reported financial position, financial performance and cash flows.**
- 23A An entity that has applied HKFRSs in a previous period, as described in paragraph 4A, shall disclose:
- (a) the reason it stopped applying HKFRSs; and
 - (b) the reason it is resuming the application of HKFRSs.
- 23B When an entity, in accordance with paragraph 4A, does not elect to apply HKFRS 1, the entity shall explain the reasons for electing to apply HKFRSs as if it had never stopped applying HKFRSs.

Reconciliations

- 24 To comply with paragraph 23, an entity's first HKFRS financial statements shall include:
- (a) reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with HKFRSs for both of the following dates:
 - (i) the date of transition to HKFRSs; and
 - (ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.
 - (b) a reconciliation to its total comprehensive income in accordance with HKFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

- (c) if the entity recognised or reversed any impairment losses for the first time in preparing its opening HKFRS statement of financial position, the disclosures that HKAS 36 *Impairment of Assets* would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to HKFRSs.

- 25 The reconciliations required by paragraph 24(a) and (b) shall give sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. If an entity presented a statement of cash flows under its previous GAAP, it shall also explain the material adjustments to the statement of cash flows.
- 26 If an entity becomes aware of errors made under previous GAAP, the reconciliations required by paragraph 24(a) and (b) shall distinguish the correction of those errors from changes in accounting policies.
- 27 HKAS 8 does not apply to the changes in accounting policies an entity makes when it adopts HKFRSs or to changes in those policies until after it presents its first HKFRS financial statements. Therefore, HKAS 8's requirements about changes in accounting policies do not apply in an entity's first HKFRS financial statements.
- 27A If during the period covered by its first HKFRS financial statements an entity changes its accounting policies or its use of the exemptions contained in this HKFRS, it shall explain the changes between its first HKFRS interim financial report and its first HKFRS financial statements, in accordance with paragraph 23, and it shall update the reconciliations required by paragraph 24(a) and (b).
- 28 If an entity did not present financial statements for previous periods, its first HKFRS financial statements shall disclose that fact.

Designation of financial assets or financial liabilities

- 29 An entity is permitted to designate a previously recognised financial asset ~~or financial liability~~ as a financial asset measured or financial liability at fair value through profit or loss ~~or a financial asset as available for sale~~ in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated ~~or financial liabilities designated into each category~~ at the date of designation and their classification and carrying amount in the previous financial statements.
- 29A An entity is permitted to designate a previously recognised financial liability as a financial liability at fair value through profit or loss in accordance with paragraph D19. The entity shall disclose the fair value of financial liabilities so designated at the date of designation and their classification and carrying amount in the previous financial statements.

Use of fair value as deemed cost

- 30 If an entity uses fair value in its opening HKFRS statement of financial position as *deemed cost* for an item of property, plant and equipment, an investment property or an intangible asset (see paragraphs D5 and D7), the entity's first HKFRS financial statements shall disclose, for each line item in the opening HKFRS statement of financial position:
- (a) the aggregate of those fair values; and
 - (b) the aggregate adjustment to the carrying amounts reported under previous GAAP.

Use of deemed cost for investments in subsidiaries, joint ventures and associates

- 31 Similarly, if an entity uses a deemed cost in its opening HKFRS statement of financial position for an investment in a subsidiary, joint venture or associate in its separate financial statements (see paragraph D15), the entity's first HKFRS separate financial statements shall disclose:
- (a) the aggregate deemed cost of those investments for which deemed cost is their previous GAAP carrying amount;

- (b) the aggregate deemed cost of those investments for which deemed cost is fair value; and
- (c) the aggregate adjustment to the carrying amounts reported under previous GAAP.

Use of deemed cost for oil and gas assets

- 31A If an entity uses the exemption in paragraph D8A(b) for oil and gas assets, it shall disclose that fact and the basis on which carrying amounts determined under previous GAAP were allocated.

Use of deemed cost for operations subject to rate regulation

- 31B If an entity uses the exemption in paragraph D8B for operations subject to rate regulation, it shall disclose that fact and the basis on which carrying amounts were determined under previous GAAP.

Use of deemed cost after severe hyperinflation

- 31C If an entity elects to measure assets and liabilities at fair value and to use that fair value as the deemed cost in its opening HKFRS statement of financial position because of severe hyperinflation (see paragraphs D26–D30), the entity's first HKFRS financial statements shall disclose an explanation of how, and why, the entity had, and then ceased to have, a functional currency that has both of the following characteristics:

- (a) a reliable general price index is not available to all entities with transactions and balances in the currency.
- (b) exchangeability between the currency and a relatively stable foreign currency does not exist.

Interim financial reports

- 32 To comply with paragraph 23, if an entity presents an interim financial report in accordance with HKAS 34 for part of the period covered by its first HKFRS financial statements, the entity shall satisfy the following requirements in addition to the requirements of HKAS 34:

- (a) Each such interim financial report shall, if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, include:
 - (i) a reconciliation of its equity in accordance with previous GAAP at the end of that comparable interim period to its equity under HKFRSs at that date; and
 - (ii) a reconciliation to its total comprehensive income in accordance with HKFRSs for that comparable interim period (current and year to date). The starting point for that reconciliation shall be 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.
- (b) In addition to the reconciliations required by (a), an entity's first interim financial report in accordance with HKAS 34 for part of the period covered by its first HKFRS financial statements shall include the reconciliations described in paragraph 24(a) and (b) (supplemented by the details required by paragraphs 25 and 26) or a cross-reference to another published document that includes these reconciliations.
- (c) If an entity changes its accounting policies or its use of the exemptions contained in this HKFRS, it shall explain the changes in each such interim financial report in accordance with paragraph 23 and update the reconciliations required by (a) and (b).

- 33 HKAS 34 requires minimum disclosures, which are based on the assumption that users of the interim financial report also have access to the most recent annual financial statements. However, HKAS 34 also requires an entity to disclose 'any events or transactions that are material to an understanding of the current interim period'. Therefore, if a first-time adopter did not, in its most recent annual financial statements in accordance with previous GAAP, disclose information material to an understanding of the current interim period, its interim financial report shall disclose that information or include a cross-reference to another published document that includes it.

Effective date

- 34 An entity shall apply this HKFRS if its first HKFRS financial statements are for a period beginning on or after 1 July 2009. Earlier application is permitted.
- 35 An entity shall apply the amendments in paragraphs D1(n) and D23 for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 23 *Borrowing Costs* (as revised in 2007) for an earlier period, those amendments shall be applied for that earlier period.
- 36 HKFRS 3 *Business Combinations* (as revised in 2008) amended paragraphs 19, C1 and C4(f) and (g). If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 37 HKAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) amended paragraphs B1 and B7. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period.
- 38 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 and HKAS 27), issued in October 2008, added paragraphs 31, D1(g), D14 and D15. An entity shall apply those paragraphs for annual periods beginning on or after 1 July 2009. Earlier application is permitted. If an entity applies the paragraphs for an earlier period, it shall disclose that fact.
- 39 Paragraph B7 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period.
- 39a An entity shall apply paragraphs B2 to B6 and D18 for annual periods beginning on or after 1 January 2005. Earlier application of those paragraphs is encouraged.
- 39A *Additional Exemptions for First-time Adopters* (Amendments to HKFRS 1), issued in August 2009, added paragraphs 31A, D8A, D9A and D21A and amended paragraph D1(c), (d) and (l). An entity shall apply those amendments for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 39B ~~[Deleted]~~~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 39C HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments* added paragraph D25. An entity shall apply that amendment when it applies HK(IFRIC)-Int 19.
- 39D ~~[Deleted]~~~~Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters (Amendment to HKFRS 1), issued in February 2010, added paragraph E3. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.~~

- 39E *Improvements to HKFRSs* issued in May 2010 added paragraphs 27A, 31B and D8B and amended paragraphs 27, 32, D1(c) and D8. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Entities that adopted HKFRSs in periods before the effective date of HKFRS 1 or applied HKFRS 1 in a previous period are permitted to apply the amendment to paragraph D8 retrospectively in the first annual period after the amendment is effective. An entity applying paragraph D8 retrospectively shall disclose that fact.
- 39F ~~[Deleted] *Disclosures – Transfers of Financial Assets* (Amendments to HKFRS 7), issued in October 2010, added paragraph E4. An entity shall apply that amendment for annual periods beginning on or after 1 July 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.~~
- 39G ~~[Deleted] [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 39H *Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters* (Amendments to HKFRS 1), issued in December 2010, amended paragraphs B2, D1 and D20 and added paragraphs 31C and D26–D30. An entity shall apply those amendments for annual periods beginning on or after 1 July 2011. Earlier application is permitted.
- 39I HKFRS 10 *Consolidated Financial Statements* and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 31, B7, C1, D1, D14 and D15 and added paragraph D31. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 39J HKFRS 13 *Fair Value Measurement*, issued in June 2011, deleted paragraph 19, amended the definition of fair value in Appendix A and amended paragraphs D15 and D20. An entity shall apply those amendments when it applies HKFRS 13.
- 39K *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 21. An entity shall apply that amendment when it applies HKAS 1 as amended in July 2011.
- 39L HKAS 19 *Employee Benefits* (as amended in July 2011) amended paragraph D1, and deleted paragraphs D10 and D11 ~~and added paragraph E5~~. An entity shall apply those amendments when it applies HKAS 19 (as amended in July 2011).
- 39M HK(IFRIC)-Int 20 *Stripping Costs in the Production Phase of a Surface Mine* added paragraph D32 and amended paragraph D1. An entity shall apply that amendment when it applies HK(IFRIC)-Int 20.
- 39N *Government Loans* (Amendments to HKFRS 1), issued in March 2012, added paragraphs B1(f) and B10–B12. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 2013. Earlier application is permitted.
- 39O Paragraphs B10 and B11 refer to HKFRS 9. If an entity applies this HKFRS but does not yet apply HKFRS 9, the references in paragraphs B10 and B11 to HKFRS 9 shall be read as references to HKAS 39 *Financial Instruments: Recognition and Measurement*.
- 39P *Annual Improvements 2009–2011 Cycle*, issued in June 2012, added paragraphs 4A–4B and 23A–23B. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

- 39Q *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraph D23. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 39R *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraph 21. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 39S *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to HKFRS 10, HKFRS 11 and HKFRS 12), issued in July 2012, amended paragraph D31. An entity shall apply that amendment when it applies HKFRS 11 (as amended in July 2012).
- 39T *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraphs D16, D17 and Appendix C ~~and added a heading and paragraphs E6–E7~~. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 39U [Deleted]
- 39V HKFRS 14 *Regulatory Deferral Accounts*, issued in February 2014, amended paragraph D8B. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies HKFRS 14 for an earlier period, the amendment shall be applied for that earlier period.
- 39W *Accounting for Acquisitions of Interests in Joint Operations* (Amendments to HKFRS 11), issued in June 2014, amended paragraph C5. An entity shall apply that amendment in annual periods beginning on or after 1 January 2016. If an entity applies related amendments to HKFRS 11 from *Accounting for Acquisitions of Interests in Joint Operations* (Amendments to HKFRS 11) in an earlier period, the amendment to paragraph C5 shall be applied in that earlier period.
- 39X-Y ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~ HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph D1, deleted paragraph D24 and its related heading and added paragraphs D34–D35 and their related heading. An entity shall apply those amendments when it applies HKFRS 15.
- 39Y HKFRS 9 *Financial Instruments*, as issued in September 2014, amended paragraph 29, B1–B6, D1, D14, D15, D19 and D20, deleted paragraphs 39B, 39G and 39U and added paragraphs 29A, B8–B8G, B9, D19A–D19C, D33, E1 and E2. An entity shall apply those amendments when it applies HKFRS 9.
- 39Z *Equity Method in Separate Financial Statements* (Amendments to HKAS 27), issued in September 2014, amended paragraph D14 and added paragraph D15A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.
- 39AA ~~[Deleted]~~ *Annual Improvements to HKFRSs 2012–2014 Cycle*, issued in October 2014, added paragraph E4A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 39AB ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included.]~~
- 39AC HK(IFRIC)-Int 22 *Foreign Currency Transactions and Advance Consideration* added paragraph

D36 and amended paragraph D1. An entity shall apply that amendment when it applies HK(IFRIC)-Int 22.

39AD *Annual Improvements to HKFRS Standards 2014–2016 Cycle*, issued in February 2017, amended paragraphs 39L and 39T and deleted paragraphs 39D, 39F, 39AA and E3–E7. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018.

Withdrawal of HKFRS 1 (issued 2003)

40 This HKFRS supersedes HKFRS 1 (issued in 2003 and amended at December 2008).

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

date of transition to HKFRSs	The beginning of the earliest period for which an entity presents full comparative information under HKFRSs in its first HKFRS financial statements .
deemed cost	An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.
fair value	<i>Fair Value</i> is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13.)
first HKFRS financial statements	The first annual financial statements in which an entity adopts Hong Kong Financial Reporting Standards (HKFRSs) , by an explicit and unreserved statement of compliance with HKFRSs.
first HKFRS reporting period	The latest reporting period covered by an entity's first HKFRS financial statements .
first-time adopter	An entity that presents its first HKFRS financial statements .
Hong Kong Financial Reporting Standards (HKFRSs)	Standards and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). They comprise: (a) Hong Kong Financial Reporting Standards; (b) Hong Kong Accounting Standards; and (c) Interpretations.
opening HKFRS statement of financial position	An entity's statement of financial position at the date of transition to HKFRSs .
previous GAAP	The basis of accounting that a first-time adopter used immediately before adopting HKFRSs.

Appendix B

Exceptions to the retrospective application of other HKFRSs

This appendix is an integral part of the HKFRSs.

B1 An entity shall apply the following exceptions:

- (a) derecognition of financial assets and financial liabilities (paragraphs B2 and B3);
- (b) hedge accounting (paragraphs B4–B6);
- (c) non-controlling interests (paragraph B7);
- (d) classification and measurement of financial assets (paragraphs B8–B8C);~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- (e) impairment of financial assets (paragraphs B8D–B8G);~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- (f) embedded derivatives (paragraph B9); and~~government loans (paragraphs B10–B12).~~
- (g) government loans (paragraphs B10–B12).

Derecognition of financial assets and financial liabilities

B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in HKFRS 9 ~~HKAS 39~~ Financial Instruments: Recognition and Measurement prospectively for transactions occurring on or after the date of transition to HKFRSs. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to HKFRSs, it shall not recognise those assets and liabilities in accordance with HKFRSs (unless they qualify for recognition as a result of a later transaction or event).

B3 ~~Despite Notwithstanding~~ paragraph B2, an entity may apply the derecognition requirements in HKFRS 9 ~~HKAS 39~~ retrospectively from a date of the entity's choosing, provided that the information needed to apply HKFRS 9 ~~HKAS 39~~ to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge accounting

B4 As required by HKFRS 9 ~~HKAS 39~~, at the date of transition to HKFRSs, an entity shall:

- (a) measure all derivatives at fair value; and
- (b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

B5 An entity shall not reflect in its opening HKFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with HKFRS 9 ~~HKAS 39~~ (for example, many hedging relationships where the hedging instrument is a stand-alone written option cash instrument or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk other than foreign currency risk; or where the hedge covers interest risk in a held-to-maturity investment). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with HKFRSs an individual item within that net position, or

a net position if that meets the requirements in paragraph 6.6.1 of HKFRS 9, provided that it does so no later than the date of transition to HKFRSs.

- B6 If, before the date of transition to HKFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in ~~HKFRS 9~~~~HKAS 39~~, the entity shall apply paragraphs 6.5.6 and 6.5.7 of ~~HKFRS 9~~~~9-91 and 101 of HKAS 39~~ to discontinue hedge accounting. Transactions entered into before the date of transition to HKFRSs shall not be retrospectively designated as hedges.

Non-controlling interests

- B7 A first-time adopter shall apply the following requirements of HKFRS 10 prospectively from the date of transition to HKFRSs:
- (a) the requirement in paragraph B94 that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;
 - (b) the requirements in paragraphs 23 and B93 for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
 - (c) the requirements in paragraphs B97 – B99 for accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

However, if a first-time adopter elects to apply HKFRS 3 retrospectively to past business combinations, it shall also apply HKFRS 10 in accordance with paragraph C1 of this HKFRS.

Classification and measurement of financial instruments

- B8 An entity shall assess whether a financial asset meets the conditions in paragraph 4.1.2 or the conditions in paragraph 4.1.2A of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs. ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- ~~B8A If it is impracticable to assess a modified time value of money element in accordance with paragraphs B4.1.9B–B4.1.9D of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition to HKFRSs without taking into account the requirements related to the modification of the time value of money element in paragraphs B4.1.9B–B4.1.9D of HKFRS 9. (In this case, the entity shall also apply paragraph 42R of HKFRS 7 but references to 'paragraph 7.2.4 of HKFRS 9' shall be read to mean this paragraph and references to 'initial recognition of the financial asset' shall be read to mean 'at the date of transition to HKFRSs'.)~~
- ~~B8B If it is impracticable to assess whether the fair value of a prepayment feature is insignificant in accordance with paragraph B4.1.12(c) of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition to HKFRSs without taking into account the exception for prepayment features in paragraph B4.1.12 of HKFRS 9. (In this case, the entity shall also apply paragraph 42S of HKFRS 7 but references to 'paragraph 7.2.5 of HKFRS 9' shall be read to mean this paragraph and references to 'initial recognition of the financial asset' shall be read to mean 'at the date of transition to HKFRSs'.)~~
- ~~B8C If it is impracticable (as defined in HKAS 8) for an entity to apply retrospectively the effective interest method in HKFRS 9, the fair value of the financial asset or the financial liability at the date of transition to HKFRSs shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to HKFRSs.~~

Impairment of financial assets

B8D An entity shall apply the impairment requirements in Section 5.5 of HKFRS 9 retrospectively subject to paragraphs B8E–B8G and E1–E2.

B8E At the date of transition to HKFRSs, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised (or for loan commitments and financial guarantee contracts the date that the entity became a party to the irrevocable commitment in accordance with paragraph 5.5.6 of HKFRS 9) and compare that to the credit risk at the date of transition to HKFRSs (also see paragraphs B7.2.2–B7.2.3 of HKFRS 9).

B8F When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

- (a) the requirements in paragraph 5.5.10 and B5.5.22–B5.5.24 of HKFRS 9; and
- (b) the rebuttable presumption in paragraph 5.5.11 of HKFRS 9 for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information.

B8G If, at the date of transition to HKFRSs, determining whether there has been a significant increase in credit risk since the initial recognition of a financial instrument would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph B8F (a) applies).

Embedded derivatives

B9 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B4.3.11 of HKFRS 9. ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~

Government loans

B10 A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with HKAS 32 *Financial Instruments: Presentation*. Except as permitted by paragraph B11, a first-time adopter shall apply the requirements in HKFRS 9 *Financial Instruments* and HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* prospectively to government loans existing at the date of transition to HKFRSs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with HKFRS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to HKFRSs as the carrying amount of the loan in the opening HKFRS statement of financial position. An entity shall apply HKFRS 9 to the measurement of such loans after the date of transition to HKFRSs.

B11 Despite paragraph B10, an entity may apply the requirements in HKFRS 9 and HKAS 20 retrospectively to any government loan originated before the date of transition to HKFRSs, provided that the information needed to do so had been obtained at the time of initially accounting for that loan.

B12 The requirements and guidance in paragraphs B10 and B11 do not preclude an entity from being able to use the exemptions described in paragraphs D19–D19C~~D~~ relating to the designation of previously recognised financial instruments at fair value through profit or loss.

Appendix C

Exemptions for business combinations

This appendix is an integral part of the HKFRS. An entity shall apply the following requirements to business combinations that the entity recognised before the date of transition to HKFRSs. This Appendix should only be applied to business combinations within the scope of HKFRS 3 Business Combinations.

- C1 A first-time adopter may elect not to apply HKFRS 3 retrospectively to past business combinations (business combinations that occurred before the date of transition to HKFRSs). However, if a first-time adopter restates any business combination to comply with HKFRS 3, it shall restate all later business combinations and shall also apply HKFRS 10 from that same date. For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X6, it shall restate all business combinations that occurred between 30 June 20X6 and the date of transition to HKFRSs, and it shall also apply HKFRS 10 from 30 June 20X6.
- C2 An entity need not apply HKAS 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 HKFRSs. If the entity does not apply HKAS 21 retrospectively to those fair value adjustments and goodwill, it shall treat them as assets and liabilities of the entity rather than as assets and liabilities of the acquiree. Therefore, those goodwill and fair value adjustments either are already expressed in the entity's functional currency or are non-monetary foreign currency items, which are reported using the exchange rate applied in accordance with previous GAAP.
- C3 An entity may apply HKAS 21 retrospectively to fair value adjustments and goodwill arising in either:
- (a) all business combinations that occurred before the date of transition to HKFRSs; or
 - (b) all business combinations that the entity elects to restate to comply with HKFRS 3, as permitted by paragraph C1 above.
- C4 If a first-time adopter does not apply HKFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:
- (a) The first-time adopter shall keep the same classification (as an acquisition by the legal acquirer, a reverse acquisition by the legal acquiree, or a uniting of interests) as in its previous GAAP financial statements.
 - (b) The first-time adopter shall recognise all its assets and liabilities at the date of transition to HKFRSs that were acquired or assumed in a past business combination, other than:
 - (i) some financial assets and financial liabilities derecognised in accordance with previous GAAP (see paragraph B2); and
 - (ii) assets, including goodwill, and liabilities that were not recognised in the acquirer's consolidated statement of financial position in accordance with previous GAAP and also would not qualify for recognition in accordance with HKFRSs in the separate statement of financial position of the acquiree (see (f)–(i) below).

The first-time adopter shall recognise any resulting change by adjusting retained earnings (or, if appropriate, another category of equity), unless the change results from the recognition of an intangible asset that was previously subsumed within goodwill (see (g)(i) below).

- (c) The first-time adopter shall exclude from its opening HKFRS statement of financial position any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under HKFRSs. The first-time adopter shall account for the resulting change as follows:
- (i) the first-time adopter may have classified a past business combination as an acquisition and recognised as an intangible asset an item that does not qualify for recognition as an asset in accordance with HKAS 38 *Intangible Assets*. It shall reclassify that item (and, if any, the related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill directly from equity in accordance with previous GAAP, see (g)(i) and (i) below).
 - (ii) the first-time adopter shall recognise all other resulting changes in retained earnings.*
- (d) HKFRSs require subsequent measurement of some assets and liabilities on a basis that is not based on original cost, such as fair value. The first-time adopter shall measure these assets and liabilities on that basis in its opening HKFRS statement of financial position, even if they were acquired or assumed in a past business combination. It shall recognise any resulting change in the carrying amount by adjusting retained earnings (or, if appropriate, another category of equity), rather than goodwill.
- (e) Immediately after the business combination, the carrying amount in accordance with previous GAAP of assets acquired and liabilities assumed in that business combination shall be their deemed cost in accordance with HKFRSs at that date. If HKFRSs require a cost-based measurement of those assets and liabilities at a later date, that deemed cost shall be the basis for cost-based depreciation or amortisation from the date of the business combination.
- (f) If an asset acquired, or liability assumed, in a past business combination was not recognised in accordance with previous GAAP, it does not have a deemed cost of zero in the opening HKFRS statement of financial position. Instead, the acquirer shall recognise and measure it in its consolidated statement of financial position on the basis that HKFRSs would require in the statement of financial position of the acquiree. To illustrate: if the acquirer had not, in accordance with its previous GAAP, capitalised finance leases acquired in a past business combination, it shall capitalise those leases in its consolidated financial statements, as HKAS 17 *Leases* would require the acquiree to do in its HKFRS statement of financial position. Similarly, if the acquirer had not, in accordance with its previous GAAP, recognised a contingent liability that still exists at the date of transition to HKFRSs, the acquirer shall recognise that contingent liability at that date unless HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would prohibit its recognition in the financial statements of the acquiree. Conversely, if an asset or liability was subsumed in goodwill in accordance with previous GAAP but would have been recognised separately under HKFRS 3, that asset or liability remains in goodwill unless HKFRSs would require its recognition in the financial statements of the acquiree.
- (g) The carrying amount of goodwill in the opening HKFRS statement of financial position shall be its carrying amount in accordance with previous GAAP at the date of transition to HKFRSs, after the following two adjustments:
- (i) If required by (c)(i) above, the first-time adopter shall increase the carrying amount of goodwill when it reclassifies an item that it recognised as an intangible asset in accordance with previous GAAP. Similarly, if (f) above requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill in accordance with previous GAAP, the first-time adopter shall decrease

* Such changes include reclassifications from or to intangible assets if goodwill was not recognised in accordance with previous GAAP as an asset. This arises if, in accordance with previous GAAP, the entity (a) deducted goodwill directly from equity or (b) did not treat the business combination as an acquisition.

the carrying amount of goodwill accordingly (and, if applicable, adjust deferred tax and non-controlling interests).

- (ii) Regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply HKAS 36 in testing the goodwill for impairment at the date of transition to HKFRSs and in recognising any resulting impairment loss in retained earnings (or, if so required by HKAS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to HKFRSs.
- (h) No other adjustments shall be made to the carrying amount of goodwill at the date of transition to HKFRSs. For example, the first-time adopter shall not restate the carrying amount of goodwill:
 - (i) to exclude in-process research and development acquired in that business combination (unless the related intangible asset would qualify for recognition in accordance with HKAS 38 in the statement of financial position of the acquiree);
 - (ii) to adjust previous amortisation of goodwill;
 - (iii) to reverse adjustments to goodwill that HKFRS 3 would not permit, but were made in accordance with previous GAAP because of adjustments to assets and liabilities between the date of the business combination and the date of transition to HKFRSs.
- (i) If the first-time adopter recognised goodwill in accordance with previous GAAP as a deduction from equity:
 - (i) it shall not recognise that goodwill in its opening HKFRS statement of financial position. Furthermore, it shall not reclassify that goodwill to profit or loss if it disposes of the subsidiary or if the investment in the subsidiary becomes impaired.
 - (ii) adjustments resulting from the subsequent resolution of a contingency affecting the purchase consideration shall be recognised in retained earnings.
- (j) In accordance with its previous GAAP, the first-time adopter may not have consolidated a subsidiary acquired in a past business combination (for example, because the parent did not regard it as a subsidiary in accordance with previous GAAP or did not prepare consolidated financial statements). The first-time adopter shall adjust the carrying amounts of the subsidiary's assets and liabilities to the amounts that HKFRSs would require in the subsidiary's statement of financial position. The deemed cost of goodwill equals the difference at the date of transition to HKFRSs between:
 - (i) the parent's interest in those adjusted carrying amounts; and
 - (ii) the cost in the parent's separate financial statements of its investment in the subsidiary.
- (k) The measurement of non-controlling interests and deferred tax follows from the measurement of other assets and liabilities. Therefore, the above adjustments to recognised assets and liabilities affect non-controlling interests and deferred tax.

C5 The exemption for past business combinations also applies to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations in which the activity of the joint operation constitutes a business, as defined in HKFRS 3. Furthermore, the date selected for paragraph C1 applies equally for all such acquisitions.

Appendix D

Exemptions from other HKFRSs

This appendix is an integral part of the HKFRS.

D1 An entity may elect to use one or more of the following exemptions:

- (a) share-based payment transactions (paragraphs D2 and D3);
- (b) insurance contracts (paragraph D4);
- (c) deemed cost (paragraphs D5–D8B);
- (d) leases (paragraphs D9 and D9A);
- (e) [deleted]
- (f) cumulative translation differences (paragraphs D12 and D13);
- (g) investments in subsidiaries, joint ventures and associates (paragraphs D14 and D15);
- (h) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs D16 and D17);
- (i) compound financial instruments (paragraph D18);
- (j) designation of previously recognised financial instruments (paragraph D19-~~D19C~~);
- (k) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph D20);
- (l) decommissioning liabilities included in the cost of property, plant and equipment (paragraphs D21 and D21A);
- (m) financial assets or intangible assets accounted for in accordance with HK(IFRIC)-Int 12 *Service Concession Arrangements* (paragraph D22);
- (n) borrowing costs (paragraph D23);
- (o) transfers of assets from customers (paragraph D24);
- (p) extinguishing financial liabilities with equity instruments (paragraph D25);
- (q) severe hyperinflation (paragraphs D26–D30);
- (r) joint arrangements (paragraph D31); ~~and~~
- (s) stripping costs in the production phase of a surface mine (paragraph D32); ~~and~~
- (t) designation of contracts to buy or sell a non-financial item (paragraph D33).
- (u) revenue (paragraphs D34 and D35); and
- (v) foreign currency transactions and advance consideration (paragraph D36).

An entity shall not apply these exemptions by analogy to other items.

Share-based payment transactions

- D2 A first-time adopter is encouraged, but not required, to apply HKFRS 2 *Share-based Payment* to equity instruments that were granted on or before 7 November 2002. A first-time adopter is also encouraged, but not required, to apply HKFRS 2 to equity instruments that were granted after 7 November 2002 and vested before the later of (a) the date of transition to HKFRSs and (b) 1 January 2005. However, if a first-time adopter elects to apply HKFRS 2 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in HKFRS 2. For all grants of equity instruments to which HKFRS 2 has not been applied (eg equity instruments granted on or before 7 November 2002), a first-time adopter shall nevertheless disclose the information required by paragraphs 44 and 45 of HKFRS 2. If a first-time adopter modifies the terms or conditions of a grant of equity instruments to which HKFRS 2 has not been applied, the entity is not required to apply paragraphs 26–29 of HKFRS 2 if the modification occurred before the date of transition to HKFRSs.
- D3 A first-time adopter is encouraged, but not required, to apply HKFRS 2 to liabilities arising from share-based payment transactions that were settled before the date of transition to HKFRSs. A first-time adopter is also encouraged, but not required, to apply HKFRS 2 to liabilities that were settled before 1 January 2005. For liabilities to which HKFRS 2 is applied, a first-time adopter is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.

Insurance contracts

- D4 A first-time adopter may apply the transitional provisions in HKFRS 4 *Insurance Contracts*. HKFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter.

Deemed cost

- D5 An entity may elect to measure an item of property, plant and equipment at the date of transition to HKFRSs at its fair value and use that fair value as its deemed cost at that date.
- D6 A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to HKFRSs as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:
- (a) fair value; or
 - (b) cost or depreciated cost in accordance with HKFRSs, adjusted to reflect, for example, changes in a general or specific price index.
- D7 The elections in paragraphs D5 and D6 are also available for:
- (a) investment property, if an entity elects to use the cost model in HKAS 40 *Investment Property*; and
 - (b) intangible assets that meet:
 - (i) the recognition criteria in HKAS 38 (including reliable measurement of original cost); and
 - (ii) the criteria in HKAS 38 for revaluation (including the existence of an active market).

An entity shall not use these elections for other assets or for liabilities.

D8 A first-time adopter may have established a deemed cost in accordance with previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering.

- (a) If the measurement date is *at or before* the date of transition to HKFRSs, the entity may use such event-driven fair value measurements as deemed cost for HKFRSs at the date of that measurement.
- (b) If the measurement date is *after* the date of transition to HKFRSs, but during the period covered by the first HKFRS financial statements, the event-driven fair value measurements may be used as deemed cost when the event occurs. An entity shall recognise the resulting adjustments directly in retained earnings (or if appropriate, another category of equity) at the measurement date. At the date of transition to HKFRSs, the entity shall either establish the deemed cost by applying the criteria in paragraphs D5–D7 or measure assets and liabilities in accordance with the other requirements in this HKFRS.

D8A Under some other accounting requirements exploration and development costs for oil and gas properties in the development or production phases are accounted for in cost centres that include all properties in a large geographical area. A first-time adopter using such accounting under previous GAAP may elect to measure oil and gas assets at the date of transition to HKFRSs on the following basis:

- (a) exploration and evaluation assets at the amount determined under the entity's previous GAAP; and
- (b) assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. The entity shall allocate this amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date.

The entity shall test exploration and evaluation assets and assets in the development and production phases for impairment at the date of transition to HKFRSs in accordance with HKFRS 6 *Exploration for and Evaluation of Mineral Resources* or HKAS 36 respectively and, if necessary, reduce the amount determined in accordance with (a) or (b) above. For the purposes of this paragraph, oil and gas assets comprise only those assets used in the exploration, evaluation, development or production of oil and gas.

D8B Some entities hold items of property, plant and equipment or intangible assets that are used, or were previously used, in operations subject to rate regulation. The carrying amount of such items might include amounts that were determined under previous GAAP but do not qualify for capitalisation in accordance with HKFRSs. If this is the case, a first-time adopter may elect to use the previous GAAP carrying amount of such an item at the date of transition to HKFRSs as deemed cost. If an entity applies this exemption to an item, it need not apply it to all items. At the date of transition to HKFRSs, an entity shall test for impairment in accordance with HKAS 36 each item for which this exemption is used. For the purposes of this paragraph, operations are subject to rate regulation if they are governed by a framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator (as defined in HKFRS 14 *Regulatory Deferral Accounts*).

Leases

D9 A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*. Therefore, a first-time adopter may determine whether an arrangement existing at the date of transition to HKFRSs contains a lease on the basis of facts and circumstances existing at that date.

D9A If a first-time adopter made the same determination of whether an arrangement contained a lease in accordance with previous GAAP as that required by HK(IFRIC)-Int 4 but at a date other than that required by HK(IFRIC)-Int 4, the first-time adopter need not reassess that determination when it adopts HKFRSs. For an entity to have made the same determination of whether the arrangement contained a lease in accordance with previous GAAP, that determination would have to have given the same outcome as that resulting from applying HKAS 17 *Leases* and HK(IFRIC)-Int 4.

D10- [Deleted]
D11

Cumulative translation differences

D12 HKAS 21 requires an entity:

- (a) to recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity; and
- (b) on disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation (including, if applicable, gains and losses on related hedges) from equity to profit or loss as part of the gain or loss on disposal.

D13 However, a first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to HKFRSs. If a first-time adopter uses this exemption:

- (a) the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to HKFRSs; and
- (b) the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to HKFRSs and shall include later translation differences.

Investments in subsidiaries, joint ventures and associates

D14 When an entity prepares separate financial statements, HKAS 27 requires it to account for its investments in subsidiaries, joint ventures and associates either:

- (a) at cost;
- (b) in accordance with HKFRS 9; or
- (c) using the equity method as described in HKAS 28.

D15 If a first-time adopter measures such an investment at cost in accordance with HKAS 27, it shall measure that investment at one of the following amounts in its separate opening HKFRS statement of financial position:

- (a) cost determined in accordance with HKAS 27; or
- (b) deemed cost. The deemed cost of such an investment shall be its:
 - (i) fair value ~~(determined in accordance with HKAS 39)~~ at the entity's date of transition to HKFRSs in its separate financial statements; or
 - (ii) previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, joint venture or associate that it elects to measure using a deemed cost.

D15A If a first-time adopter accounts for such an investment using the equity method procedures as described in HKAS 28:

- (a) the first-time adopter applies the exemption for past business combinations (Appendix C) to the acquisition of the investment.
- (b) if the entity becomes a first-time adopter for its separate financial statements earlier than for its consolidated financial statements, and
 - (i) later than its parent, the entity shall apply paragraph D16 in its separate financial statements.
 - (ii) later than its subsidiary, the entity shall apply paragraph D17 in its separate financial statements.

Assets and liabilities of subsidiaries, associates and joint ventures

D16 If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:

- (a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to HKFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this election is not available to a subsidiary of an investment entity, as defined in HKFRS 10, that is required to be measured at fair value through profit or loss); or
- (b) the carrying amounts required by the rest of this HKFRS, based on the subsidiary's date of transition to HKFRSs. These carrying amounts could differ from those described in (a):
 - (i) when the exemptions in this HKFRS result in measurements that depend on the date of transition to HKFRSs.
 - (ii) when the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in HKAS 16 *Property, Plant and Equipment*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

D17 However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. Notwithstanding this requirement, a non-investment entity parent shall not apply the exception to consolidation that is used by any investment entity subsidiaries. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

Compound financial instruments

- D18 HKAS 32 *Financial Instruments: Presentation* requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of HKAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, in accordance with this HKFRS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to HKFRSs.

Designation of previously recognised financial instruments

- D19 ~~HKAS 39~~ HKFRS 9 permits a financial liability asset to be designated on initial recognition as available for sale or a financial instrument (provided it meets certain criteria) to be designated as a financial asset or financial liability at fair value through profit or loss. Despite this requirement an entity is permitted to designate, at the date of transition to HKFRSs, any financial liability as at fair value through profit or loss provided the liability meets the criteria in paragraph 4.2.2 of HKFRS 9 at that date. ~~exceptions apply in the following circumstances:~~

- ~~(a) an entity is permitted to make an available for sale designation at the date of transition to HKFRSs.~~
- ~~(b) an entity is permitted to designate, at the date of transition to HKFRSs, any financial asset or financial liability as at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A of HKAS 39 at that date.~~

- D19A An entity may designate a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

- D19B An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

- D19C For a financial liability that is designated as a financial liability at fair value through profit or loss, an entity shall determine whether the treatment in paragraph 5.7.7 of HKFRS 9 would create an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

Fair value measurement of financial assets or financial liabilities at initial recognition

- D20 ~~Notwithstanding~~ Despite the requirements of paragraphs 7 and 9, an entity may apply the requirements in paragraph ~~AG76(a) of HKAS 39~~ B5.1.2A(b) of HKFRS 9 prospectively to transactions entered into on or after the date of transition to HKFRSs.

Decommissioning liabilities included in the cost of property, plant and equipment

- D21 HK(IFRIC)-Int 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. A first-time adopter need not comply with these requirements for changes in such liabilities that occurred before the date of transition to HKFRSs. If a first-time adopter uses this exemption, it shall:

- (a) measure the liability as at the date of transition to HKFRSs in accordance with HKAS 37;
- (b) to the extent that the liability is within the scope of HK(IFRIC)-Int 1, estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period; and
- (c) calculate the accumulated depreciation on that amount, as at the date of transition to HKFRSs, on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity in accordance with HKFRSs.

D21A An entity that uses the exemption in paragraph D8A(b) (for oil and gas assets in the development or production phases accounted for in cost centres that include all properties in a large geographical area under previous GAAP) shall, instead of applying paragraph D21 or HK(IFRIC)-Int 1:

- (a) measure decommissioning, restoration and similar liabilities as at the date of transition to HKFRSs in accordance with HKAS 37; and
- (b) recognise directly in retained earnings any difference between that amount and the carrying amount of those liabilities at the date of transition to HKFRSs determined under the entity's previous GAAP.

Financial assets or intangible assets accounted for in accordance with HK(IFRIC)-Int 12

D22 A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 12.

Borrowing costs

D23 A first-time adopter can elect to apply the requirements of HKAS 23 from the date of transition or from an earlier date as permitted by paragraph 28 of HKAS 23. From the date on which an entity that applies this exemption begins to apply HKAS 23, the entity:

- (a) shall not restate the borrowing cost component that was capitalised under previous GAAP and that was included in the carrying amount of assets at that date; and
- (b) shall account for borrowing costs incurred on or after that date in accordance with HKAS 23, including those borrowing costs incurred on or after that date on qualifying assets already under construction.

~~Transfers of assets from customers~~

D24 ~~[Deleted] A first-time adopter may apply the transitional provisions set out in paragraph 22 of HK(IFRIC)-Int 18 *Transfers of Assets from Customers*. In that paragraph, reference to the effective date shall be interpreted as 1 July 2009 or the date of transition to HKFRSs, whichever is later. In addition, a first-time adopter may designate any date before the date of transition to HKFRSs and apply HK(IFRIC)-Int 18 to all transfers of assets from customers received on or after that date.~~

Extinguishing financial liabilities with equity instruments

D25 A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments*.

Severe hyperinflation

- D26 If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of transition to HKFRSs. This applies to entities that are adopting HKFRSs for the first time, as well as entities that have previously applied HKFRSs.
- D27 The currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics:
- (a) a reliable general price index is not available to all entities with transactions and balances in the currency.
 - (b) exchangeability between the currency and a relatively stable foreign currency does not exist.
- D28 The functional currency of an entity ceases to be subject to severe hyperinflation on the functional currency normalisation date. That is the date when the functional currency no longer has either, or both, of the characteristics in paragraph D27, or when there is a change in the entity's functional currency to a currency that is not subject to severe hyperinflation.
- D29 When an entity's date of transition to HKFRSs is on, or after, the functional currency normalisation date, the entity may elect to measure all assets and liabilities held before the functional currency normalisation date at fair value on the date of transition to HKFRSs. The entity may use that fair value as the deemed cost of those assets and liabilities in the opening HKFRS statement of financial position.
- D30 When the functional currency normalisation date falls within a 12-month comparative period, the comparative period may be less than 12 months, provided that a complete set of financial statements (as required by paragraph 10 of HKAS 1) is provided for that shorter period.

Joint arrangements

- D31 A first-time adopter may apply the transition provisions in HKFRS 11 with the following exceptions:
- (a) When applying the transition provisions in HKFRS 11, a first-time adopter shall apply these provisions at the date of transition to HKFRS.
 - (b) When changing from proportionate consolidation to the equity method, a first-time adopter shall test for impairment the investment in accordance with HKAS 36 as at the date of transition to HKFRS, regardless of whether there is any indication that the investment may be impaired. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to HKFRS.

Stripping costs in the production phase of a surface mine

- D32 A first-time adopter may apply the transitional provisions set out in paragraphs A1 to A4 of HK(IFRIC)-Int 20 *Stripping Costs in the Production Phase of a Surface Mine*. In that paragraph, reference to the effective date shall be interpreted as 1 January 2013 or the beginning of the first HKFRS reporting period, whichever is later.

Designation of contracts to buy or sell a non-financial item

- D33 HKFRS 9 permits some contracts to buy or sell a non-financial item to be designated at inception as measured at fair value through profit or loss (see paragraph 2.5 of HKFRS 9). Despite this requirement an entity is permitted to designate, at the date of transition to HKFRSs, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the requirements of paragraph 2.5 of HKFRS 9 at that date and the entity designates all similar

contracts.

Revenue

- D34 A first-time adopter may apply the transition provisions in paragraph C5 of HKFRS 15. In those paragraphs references to the ‘date of initial application’ shall be interpreted as the beginning of the first HKFRS reporting period. If a first-time adopter decides to apply those transition provisions, it shall also apply paragraph C6 of HKFRS 15.
- D35 A first-time adopter is not required to restate contracts that were completed before the earliest period presented. A completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with previous GAAP.

Foreign Currency Transactions and Advance Consideration

- D36 A first-time adopter need not apply HK(IFRIC)-Int 22 *Foreign Currency Transactions and Advance Consideration* to assets, expenses and income in the scope of that Interpretation initially recognised before the date of transition to HKFRS Standards.

Appendix E

Short-term exemptions from HKFRSs

This appendix is an integral part of the HKFRS.

~~[Paragraphs E1 and E2 are amendments that are not yet effective and are therefore not included in this edition.]~~

Exemption from the requirement to restate comparative information for HKFRS 9

- ~~E1 If an entity's first HKFRS reporting period begins before 1 January 2019 and the entity applies the completed version of HKFRS 9 (issued in 2014), the comparative information in the entity's first HKFRS financial statements need not comply with HKFRS 7 *Financial Instruments: Disclosure* or the completed version of HKFRS 9 (issued in 2014), to the extent that the disclosures required by HKFRS 7 relate to items within the scope of HKFRS 9. For such entities, references to the 'date of transition to HKFRSs' shall mean, in the case of HKFRS 7 and HKFRS 9 (2014) only, the beginning of the first HKFRS reporting period.~~
- ~~E2 An entity that chooses to present comparative information that does not comply with HKFRS 7 and the completed version of HKFRS 9 (issued in 2014) in its first year of transition shall:~~
- ~~(a) apply the requirements of its previous GAAP in place of the requirements of HKFRS 9 to comparative information about items within the scope of HKFRS 9.~~
 - ~~(b) disclose this fact together with the basis used to prepare this information.~~
 - ~~(c) treat any adjustment between the statement of financial position at the comparative period's reporting date (ie the statement of financial position that includes comparative information under previous GAAP) and the statement of financial position at the start of the first HKFRS reporting period (ie the first period that includes information that complies with HKFRS 7 and the completed version of HKFRS 9 (issued in 2014)) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)–(e) and (f)(i) of HKAS 8. Paragraph 28(f)(i) applies only to amounts presented in the statement of financial position at the comparative period's reporting date.~~
 - ~~(d) apply paragraph 17(c) of HKAS 1 to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.~~

Disclosures about financial instruments

- ~~E3 [Deleted] A first-time adopter may apply the transition provisions in paragraph 44G of HKFRS 7.*~~
- ~~E4 [Deleted] A first-time adopter may apply the transitional provisions in paragraph 44M of HKFRS 7.†~~
- ~~E4A [Deleted] A first-time adopter may apply the transition provisions in paragraph 44AA of HKFRS 7.~~

* Paragraph E3 was added as a consequence of *Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters* (Amendment to HKFRS 1) issued in February 2010. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current HKFRS preparers, first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with HKFRSs that are included in *Improving Disclosures about Financial Instruments* (Amendments to HKFRS 7).

† Paragraph E4 was added as a consequence of *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7) issued in October 2010. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current HKFRS preparers, first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with HKFRSs that are included in *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7).

Employee benefits

- E5 ~~[Deleted] A first-time adopter may apply the transition provisions in paragraph 173(b) of HKAS 19.~~

Investment entities

- E6 ~~[Deleted] A first-time adopter that is a parent shall assess whether it is an investment entity, as defined in HKFRS 10, on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.~~
- E7 ~~[Deleted] A first-time adopter that is an investment entity, as defined in HKFRS 10, may apply the transition provisions in paragraphs C3C–C3D of HKFRS 10 and paragraphs 18C–18G of HKAS 27 (2011) if its first HKFRS financial statements are for an annual period ending on or before 31 December 2014. The references in those paragraphs to the annual period that immediately precedes the date of initial application shall be read as the earliest annual period presented. Consequently, the references in those paragraphs shall be read as the date of transition to HKFRSs.~~

APPENDIX F

Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared as at December 2008 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKFRS 1.

The International Financial Reporting Standard comparable with HKFRS 1 (Revised) is IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

The following sets out the major textual differences between HKFRS 1 (Revised) and IFRS 1 and the reasons for such differences.

Differences	Reasons for the differences
1. IFRS 1 Paras 3(a) and 4 HKFRS 1 Paras 3(a) and 4 IFRS 1 contains references to "national" requirements whereas HKFRS 1 uses references to "other accounting" requirements.	IFRS 1 is an international statement whereas HKFRS 1 is a national statement.

HKFRS 1 (Revised) BC
Revised September 2018~~December 2016~~

Effective for annual periods
beginning on or after 1 July 2009

*Basis for Conclusions on
Hong Kong Financial Reporting Standards 1 (Revised)*

First-time Adoption of Hong Kong Financial Reporting Standards



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Basis for Conclusions

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

HKFRS 1 (Revised) is based on IFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*. In approving HKFRS 1 (Revised), the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 1. Accordingly, there are no significant differences between HKFRS 1 (Revised) and IFRS 1. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 1 referred to below generally correspond with those in HKFRS 1 (Revised).

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Basis for Conclusions on IFRS 1 *First-time Adoption of International Financial Reporting Standards*

This Basis for Conclusions accompanies, but is not part of, IFRS 1.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements (as revised in 2007).

This Basis for Conclusions has not been revised to reflect the restructuring of FRS 1 in November 2008, but cross-references have been updated.

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Individual Board members gave greater weight to some factors than to others.
- BC2 SIC-8 *First-time Application of IASs as the Primary Basis of Accounting*, issued in 1998, dealt with matters that arose when an entity first adopted IASs. In 2001, the Board began a project to review SIC-8. In July 2002, the Board published ED 1 *First-time Application of International Financial Reporting Standards*, with a comment deadline of 31 October 2002. The Board received 83 comment letters on ED 1. IFRS 1 was issued by the Board in June 2003.
- BC2A IFRS 1 replaced SIC-8. The Board developed the IFRS to address concerns that:
- (a) some aspects of SIC-8's requirement for full retrospective application caused costs that exceeded the likely benefits for users of financial statements. Moreover, although SIC-8 did not require retrospective application when this would be impracticable, it did not explain whether a first-time adopter should interpret impracticability as a high hurdle or a low hurdle and it did not specify any particular treatment in cases of impracticability.
 - (b) SIC-8 could require a first-time adopter to apply two different versions of a standard if a new version were introduced during the periods covered by its first financial statements prepared under IASs and the new version prohibited retrospective application.
 - (c) SIC-8 did not state clearly whether a first-time adopter should use hindsight in applying recognition and measurement decisions retrospectively.
 - (d) there was some doubt about how SIC-8 interacted with specific transitional provisions in individual standards.
- BC2B Like SIC-8, IFRS 1 requires retrospective application in most areas. Unlike SIC-8, it:
- (a) includes targeted exemptions to avoid costs that would be likely to exceed the benefits to users of financial statements, and a small number of other exceptions for practical reasons.
 - (b) clarifies that an entity applies the latest version of IFRSs.
 - (c) clarifies how a first-time adopter's estimates in accordance with IFRSs relate to the estimates it made for the same date in accordance with previous GAAP.

- (d) specifies that the transitional provisions in other IFRSs do not apply to a first-time adopter.
- (e) requires enhanced disclosure about the transition to IFRSs.

BC3 The project took on added significance because of the requirement for listed European Union companies to adopt IFRSs in their consolidated financial statements from 2005. Several other countries announced that they would permit or require entities to adopt IFRSs in the next few years. Nevertheless, the Board's aim in developing the IFRS was to find solutions that would be appropriate for any entity, in any part of the world, regardless of whether adoption occurs in 2005 or at a different time.

Restructuring of the IFRS

BC3A Since it was issued in 2003, IFRS 1 has been amended many times to accommodate first-time adoption requirements resulting from new or amended IFRSs. Because of the way IFRS 1 was structured, those amendments made the IFRS more complex and less clear. As more amendments become necessary, this problem will become worse.

BC3B As part of its improvements project in 2007, therefore, the Board proposed to change the structure of IFRS 1 without amending its substance. Respondents to the exposure draft published in October 2007 supported the restructuring. The revised structure of the IFRS issued in November 2008 is easier for the reader to understand and is better designed to accommodate future changes. The focus of the restructuring was to move to appendices all specific exemptions and exceptions from the requirements of IFRSs. Exemptions are categorised into business combinations, exemptions and short-term exemptions. Exemptions are applicable to all first-time adopters regardless of their date of transition to IFRSs. Short-term exemptions are those exemptions applicable to users for a short time. Once those exemptions have become out of date, they will be deleted.

Scope

BC4 The IFRS applies to an entity that presents its first IFRS financial statements (a first-time adopter). Some suggested that an entity should not be regarded as a first-time adopter if its previous financial statements contained an explicit statement of compliance with IFRSs, except for specified (and explicit) departures. They argued that an explicit statement of compliance establishes that an entity regards IFRSs as its basis of accounting, even if the entity does not comply with every requirement of every IFRS. Some regarded this argument as especially strong if an entity previously complied with all recognition and measurement requirements of IFRSs, but did not give some required disclosures—for example, segmental disclosures that IAS 14 *Segment Reporting** requires or the explicit statement of compliance with IFRSs that IAS 1 *Presentation of Financial Statements* requires.

BC5 To implement that approach, it would be necessary to establish how many departures are needed—and how serious they must be—before an entity would conclude that it has not adopted IFRSs. In the Board's view, this would lead to complexity and uncertainty. Also, an entity should not be regarded as having adopted IFRSs if it does not give all disclosures required by IFRSs, because that approach would diminish the importance of disclosures and undermine efforts to promote full compliance with IFRSs. Therefore, the IFRS contains a simple test that gives an unambiguous answer: an entity has adopted IFRSs if, and only if, its financial statements contain an explicit and unreserved statement of compliance with IFRSs (paragraph 3 of the IFRS).

BC6 If an entity's financial statements in previous years contained that statement, any material disclosed or undisclosed departures from IFRSs are errors. The entity applies IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in correcting them.

* In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*.

Repeated application of IFRS 1

BC6A In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed a request to clarify whether an entity may apply IFRS 1:

- (a) if the entity meets the criteria for applying IFRS 1 and has applied IFRS 1 in a previous reporting period; or
- (b) if the entity meets the criteria for applying IFRS 1 and has applied IFRSs in a previous reporting period when IFRS 1 did not exist.

For example, an entity may have applied IFRS 1 in a previous reporting period to meet listing requirements in a foreign jurisdiction. The entity then delists and no longer presents financial statements in accordance with IFRSs. In a subsequent reporting period, the reporting requirements in the entity's local jurisdiction may change from national GAAP to IFRSs. Consequently, the entity is again required to present its financial statements in accordance with IFRSs.

BC6B The Board noted that the scope of IFRS 1 focuses on whether an entity's financial statements are its first IFRS financial statements (a term defined in Appendix A). If an entity's financial statements meet the definition of 'first IFRS financial statements', the entity is required to apply IFRS 1 in accordance with paragraph 2(a). However, use of the term 'first' raises the question whether IFRS 1 can be applied more than once.

BC6C In the June 2011 exposure draft the Board proposed to clarify that an entity is required to apply IFRS 1 when the entity's most recent previous annual financial statements do not contain an explicit and unreserved statement of compliance with IFRSs, even if the entity has applied IFRS 1 in a reporting period before the period reported in the most recent previous annual financial statements. However, in the light of respondents' comments on the June 2011 exposure draft, the Board decided that an entity that meets the criteria for applying IFRS 1 and that has applied IFRSs in a previous reporting period (regardless of whether it used IFRS 1 or SIC-8 *First-Time Application of IASs*, if either, when previously adopting) may choose to apply IFRS 1 when it re-adopts IFRSs. The Board decided that the entity should be allowed, rather than required, to apply IFRS 1 because, as explained in paragraph IN5 of IFRS 1, IFRS 1 grants limited exemptions from some requirements of IFRSs on the assumption that the cost of complying with some IFRSs would be likely to exceed the benefits to users of financial statements. However, the costs of applying IFRSs in full might not exceed the benefits of doing so for an entity that had previously applied IFRSs. Consequently, the Board concluded that an entity returning to IFRSs might determine that the benefits of applying IFRSs as if it had continued to do so without interruption would exceed the costs of preparing such information, and that an entity should not be prohibited from following that approach. In applying such an approach, an entity should apply IFRSs retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Estimates and Errors* as if the entity had never stopped applying IFRSs. The Board noted that hindsight is not applied by an entity in preparing IFRS financial statements, whether that entity is applying IFRS 1, or whether that entity applies IFRSs retrospectively as if the entity had never stopped applying them in accordance with IAS 8. The Board noted that paragraphs 14–17 of IFRS 1 and paragraph 53 of IAS 8 provide guidance in this regard.

BC6D The Board also noted that, in accordance with paragraph 2 of IFRS 1, an entity that has never applied IFRSs in the past would continue to be required to apply IFRS 1 in its first IFRS financial statements.

BC6E The Board also decided that the entity shall disclose the reason why it stopped applying IFRSs and the reason why it is resuming reporting in accordance with IFRSs. The Board thinks that this disclosure requirement provides users with useful information and would discourage the intentional omission of the statement of compliance with IFRSs solely to allow an entity to take advantage of the exemptions in IFRS 1. The Board also decided that an entity that does not elect to apply IFRS 1 shall explain the reasons why it has elected to apply IFRSs as if it had never stopped applying them. The Board believes that this disclosure ensures that useful information will be provided to users.

Basic concepts

Useful information for users

- BC7 In developing recognition and measurement requirements for an entity's opening IFRS balance sheet, the Board referred to the objective of financial statements, as set out in the *Framework for the Preparation and Presentation of Financial Statements*. The *Framework*^{*} states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.
- BC8 The *Framework* identifies four qualitative characteristics that make information in financial statements useful to users. In summary, the information should be:
- (a) readily understandable by users.
 - (b) relevant to the decision-making needs of users.
 - (c) reliable, in other words financial statements should:
 - (i) represent faithfully the transactions and other events they either purport to represent or could reasonably be expected to represent;
 - (ii) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;
 - (iii) be neutral, that is to say, free from bias;
 - (iv) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and
 - (v) be complete within the bounds of materiality and cost.
 - (d) comparable with information provided by the entity in its financial statements through time and with information provided in the financial statements of other entities.

Comparability

- BC9 The previous paragraph notes the need for comparability. Ideally, a regime for first-time adoption of IFRSs would achieve comparability:
- (a) within an entity over time;
 - (b) between different first-time adopters; and
 - (c) between first-time adopters and entities that already apply IFRSs.
- BC10 SIC-8 gave priority to ensuring comparability between a first-time adopter and entities that already applied IASs. It was based on the principle that a first-time adopter should comply with the same standards as an entity that already applied IASs. However, the Board decided that it is more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective.

^{*} References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

Current version of IFRSs

- BC11 Paragraphs 7–9 of the IFRS require a first-time adopter to apply the current version of IFRSs, without considering superseded or amended versions[†]. This:
- (a) enhances comparability, because the information in a first-time adopter's first IFRS financial statements is prepared on a consistent basis over time;
 - (b) gives users comparative information prepared using later versions of IFRSs that the Board regards as superior to superseded versions; and
 - (c) avoids unnecessary costs.
- BC11A Paragraph 7 requires an entity to use the IFRSs that are effective at the end of its first IFRS reporting period. Paragraph 8 allows a first-time adopter to apply a new IFRS that is not yet mandatory if that IFRS permits early application. Notwithstanding the advantages, set out in paragraph BC11, of applying a more recent version of an IFRS, paragraphs 7–8 permit an entity to use either the IFRS that is currently mandatory or the new IFRS that is not yet mandatory, if that new IFRS permits early application. Paragraph 7 requires an entity to apply the same version of the IFRS throughout the periods covered by the entity's first IFRS financial statements. Consequently, if a first-time adopter chooses to early apply a new IFRS, that new IFRS will be applied throughout all the periods presented in its first IFRS financial statements on a retrospective basis, unless IFRS 1 provides an exemption or an exception that permits or requires otherwise.
- BC12 In general, the transitional provisions in other IFRSs do not apply to a first-time adopter (paragraph 9 of the IFRS). Some of these transitional provisions require or permit an entity already reporting in accordance with IFRSs to apply a new requirement prospectively. These provisions generally reflect a conclusion that one or both of the following factors are present in a particular case:
- (a) Retrospective application may be difficult or involve costs exceeding the likely benefits. The IFRS permits prospective application in specific cases where this could occur (paragraphs BC30–BC73).
 - (b) There is a danger of abuse if retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known. The IFRS prohibits retrospective application in some areas where this could occur (paragraphs BC74–BC84).
- BC13 Some have suggested three further reasons for permitting or requiring prospective application in some cases:
- (a) to alleviate unforeseen consequences of a new IFRS if another party uses financial statements to monitor compliance with a contract or agreement. However, in the Board's view, it is up to the parties to an agreement to determine whether to insulate the agreement from the effects of a future IFRS and, if not, how they might renegotiate it so that it reflects changes in the underlying financial condition rather than changes in reporting (paragraph 21* of the *Preface to International Financial Reporting Standards*).

[†] *Annual Improvements Cycle 2011–2013* clarified that this paragraph does not require an entity to use a more recent version of an IFRS. It only explains the advantages of applying a more recent version of an IFRS. See paragraph BC11A for further details.

* amended to paragraph 20 when the *Preface* was revised in January 2010.

- (b) to give a first-time adopter the same accounting options as an entity that already applies IFRSs. However, permitting prospective application by a first-time adopter would conflict with the Board's primary objective of comparability within an entity's first IFRS financial statements (paragraph BC10). Therefore, the Board did not adopt a general policy of giving first-time adopters the same accounting options of prospective application that existing IFRSs give to entities that already apply IFRSs. Paragraphs BC20–BC23 discuss one specific case, namely derecognition of financial assets and financial liabilities.
- (c) to avoid difficult distinctions between changes in estimates and changes in the basis for making estimates. However, a first-time adopter need not make this distinction in preparing its opening IFRS balance sheet, so the IFRS does not include exemptions on these grounds. If an entity becomes aware of errors made under previous GAAP, the IFRS requires it to disclose the correction of the errors (paragraph 26 of the IFRS).

BC14 The Board will consider case by case when it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. However, if the Board concludes in a particular case that prospective application by a first-time adopter is justified, it will amend the IFRS on first-time adoption of IFRSs. As a result, IFRS 1 will contain all material on first-time adoption of IFRSs and other IFRSs will not refer to first-time adopters (except, when needed, in the Basis for Conclusions and consequential amendments).

BC15 Under the proposals in ED 1, a first-time adopter could have elected to apply IFRSs as if it had always applied IFRSs. This alternative approach was intended mainly to help an entity that did not wish to use any of the exemptions proposed in ED 1 because it had already been accumulating information in accordance with IFRSs without presenting IFRS financial statements. To enable an entity using this approach to use the information it had already accumulated, ED 1 would have required it to consider superseded versions of IFRSs if more recent versions required prospective application. However, as explained in paragraphs BC28 and BC29, the Board abandoned ED 1's all-or-nothing approach to exemptions. Because this eliminated the reason for the alternative approach, the Board deleted it in finalising the IFRS.

Opening IFRS balance sheet

BC16 An entity's opening IFRS balance sheet is the starting point for its accounting in accordance with IFRSs. The following paragraphs explain how the Board used the *Framework* in developing recognition and measurement requirements for the opening IFRS balance sheet.

Recognition

BC17 The Board considered a suggestion that the IFRS should not require a first-time adopter to investigate transactions that occurred before the beginning of a 'look back' period of, say, three to five years before the date of transition to IFRSs. Some argued that this would be a practical way for a first-time adopter to give a high level of transparency and comparability, without incurring the cost of investigating very old transactions. They noted two particular precedents for transitional provisions that have permitted an entity to omit some assets and liabilities from its balance sheet:

- (a) A previous version of IAS 39 *Financial Instruments: Recognition and Measurement*^{*} prohibited restatement of securitisation, transfer or other derecognition transactions entered into before the beginning of the financial year in which it was initially applied.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (b) Some national accounting standards and IAS 17 *Accounting for Leases* (superseded in 1997 by IAS 17 *Leases*) permitted prospective application of a requirement for lessees to capitalise finance leases. Under this approach, a lessee would not be required to recognise finance lease obligations and the related leased assets for leases that began before a specified date.
- BC18 However, limiting the look back period could lead to the omission of material assets or liabilities from an entity's opening IFRS balance sheet. Material omissions would undermine the understandability, relevance, reliability and comparability of an entity's first IFRS financial statements. Therefore, the Board concluded that an entity's opening IFRS balance sheet should:
- (a) include all assets and liabilities whose recognition is required by IFRSs, except:
- (i) some financial assets or financial liabilities derecognised in accordance with previous GAAP before the date of transition to IFRSs (paragraphs BC20–BC23); and
- (ii) goodwill and other assets acquired, and liabilities assumed, in a past business combination that were not recognised in the acquirer's consolidated balance sheet in accordance with previous GAAP and also would not qualify for recognition in accordance with IFRSs in the balance sheet of the acquiree (paragraphs BC31–BC40).
- (b) not report items as assets or liabilities if they do not qualify for recognition in accordance with IFRSs.
- BC19 Some financial instruments may be classified as equity in accordance with previous GAAP but as financial liabilities in accordance with IAS 32 *Financial Instruments: Presentation*. Some respondents to ED 1 requested an extended transitional period to enable the issuer of such instruments to renegotiate contracts that refer to debt-equity ratios. However, although a new IFRS may have unforeseen consequences if another party uses financial statements to monitor compliance with a contract or agreement, that possibility does not, in the Board's view, justify prospective application (paragraph BC13(a)).

Derecognition in accordance with previous GAAP

- BC20 An entity may have derecognised financial assets or financial liabilities in accordance with its previous GAAP that do not qualify for derecognition in accordance with IAS 39.* ED 1 proposed that a first-time adopter should recognise those assets and liabilities in its opening IFRS balance sheet. Some respondents to ED 1 requested the Board to permit or require a first-time adopter not to restate past derecognition transactions, on the following grounds:
- (a) Restating past derecognition transactions would be costly, especially if restatement involves determining the fair value of retained servicing assets and liabilities and other components retained in a complex securitisation. Furthermore, it may be difficult to obtain information on financial assets held by transferees that are not under the transferor's control.
- (b) Restatement undermines the legal certainty expected by parties who entered into transactions on the basis of the accounting rules in effect at the time.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (c) IAS 39 did not, before the improvements proposed in June 2002, require (or even permit) entities to restate past derecognition transactions. Without a similar exemption, first-time adopters would be unfairly disadvantaged.
 - (d) Retrospective application would not result in consistent measurement, as entities would need to recreate information about past transactions with the benefit of hindsight.
- BC21 The Board had considered these arguments in developing ED 1. The Board's reasons for the proposal in ED 1 were as follows:
- (a) The omission of material assets or liabilities would undermine the understandability, relevance, reliability and comparability of an entity's financial statements. Many of the transactions under discussion are large and will have effects for many years.
 - (b) Such an exemption would be inconsistent with the June 2002 exposure draft of improvements to IAS 39.
 - (c) The Board's primary objective is to achieve comparability over time within an entity's first IFRS financial statements. Prospective application by a first-time adopter would conflict with that primary objective, even if prospective application were available to entities already applying IFRSs.
 - (d) Although a new IFRS may have unforeseen consequences if another party uses financial statements to monitor compliance with a contract or agreement, that possibility does not justify prospective application (paragraph BC13(a)).
- BC22 Nevertheless, in finalising the IFRS, the Board concluded that it would be premature to require a treatment different from the current version of IAS 39 before completing the proposed improvements to IAS 39. Accordingly, the IFRS originally required the same treatment as the then current version of IAS 39 for derecognition transactions before the effective date of the then current version of IAS 39, namely that any financial assets or financial liabilities derecognised in accordance with previous GAAP before financial years beginning on 1 January 2001 remain derecognised. The Board agreed that when it completed the improvements to IAS 39, it might amend or delete this exemption.
- BC22A The Board reconsidered this issue in completing the revision of IAS 39 in 2003. The Board decided to retain the transition requirements as set out in IFRS 1, for the reasons given in paragraph BC20. However, the Board amended the date from which prospective application was required to transactions that occur on or after 1 January 2004 in order to overcome the practical difficulties of restating transactions that had been derecognised before that date. In 2010 the Board was asked to reconsider whether 1 January 2004 is the appropriate date from which a first-time adopter should be required to restate past derecognition transactions. Constituents were concerned that, as time passes, the fixed transition date of 1 January 2004 becomes more remote and increasingly less relevant to the financial reports as additional jurisdictions adopt IFRSs. The Board accepted that the cost of reconstructing transactions back in time to 1 January 2004 was likely to outweigh the benefit to be achieved in doing so. It therefore amended the fixed date of 1 January 2004 in paragraph B2 to 'the date of transition to IFRSs'. The Board also amended the wording of the illustration in paragraph B2, in order to clarify that it is providing an example.
- BC22B The Board also noted that financial statements that include financial assets and financial liabilities that would otherwise be omitted under the provisions of the IFRS would be more complete and therefore more useful to users of financial statements. The Board therefore decided to permit retrospective application of the derecognition requirements. It also decided that retrospective application should be limited to cases when the information needed to apply the IFRS to past transactions was obtained at the time of initially accounting for those transactions. This limitation prevents the unacceptable use of hindsight.

BC23 The Board removed from IAS 39 the following consequential amendments to IAS 39 made when IFRS 1 was issued, because, for first-time adopters, these clarifications are clear in paragraphs IG26–IG31 and IG53 of the guidance on implementing IFRS 1. These were:

- (a) the clarification that an entity is required to apply IAS 39 to all derivatives or other interests retained after a derecognition transaction, even if the transaction occurred before the effective date of IAS 39; and
- (b) the confirmation that there are no exemptions for special purpose entities* that existed before the date of transition to IFRSs.

Measurement

BC24 The Board considered whether it should require a first-time adopter to measure all assets and liabilities at fair value in the opening IFRS balance sheet. Some argued that this would result in more relevant information than an aggregation of costs incurred at different dates, or of costs and fair values. However, the Board concluded that a requirement to measure all assets and liabilities at fair value at the date of transition to IFRSs would be unreasonable, given that an entity may use an IFRS-compliant cost-based measurement before and after that date for some items.

BC25 The Board decided as a general principle that a first-time adopter should measure all assets and liabilities recognised in its opening IFRS balance sheet on the basis required by the relevant IFRSs. This is needed for an entity's first IFRS financial statements to present understandable, relevant, reliable and comparable information.

Benefits and costs

BC26 The *Framework* acknowledges that the need for a balance between the benefits of information and the cost of providing it may constrain the provision of relevant and reliable information. The Board considered these cost-benefit constraints and developed targeted exemptions from the general principle described in paragraph BC25. SIC-8 did not include specific exemptions of this kind, although it provided general exemptions from:

- (a) retrospective adjustments to the opening balance of retained earnings 'when the amount of the adjustment relating to prior periods cannot be reasonably determined'.
- (b) provision of comparative information when it is 'impracticable' to provide such information.

BC27 The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board took as its benchmark an entity that plans the transition well in advance and can collect most information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs.

BC28 ED 1 proposed that a first-time adopter should use either all the exemptions in ED 1 or none. However, some respondents disagreed with this all or nothing approach for the following reasons:

- (a) Many of the exemptions are not interdependent, so there is no conceptual reason to condition use of one exemption on use of other exemptions.
- (b) Although it is necessary to permit some exemptions on pragmatic grounds, entities should be encouraged to use as few exemptions as possible.

* SIC-12 *Consolidation-Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

- (c) Some of the exemptions proposed in ED 1 were implicit options because they relied on the entity's own judgement of undue cost or effort and some others were explicit options. Only a few exemptions were really mandatory.
- (d) Unlike the other exceptions to retrospective application, the requirement to apply hedge accounting prospectively was not intended as a pragmatic concession on cost benefit grounds. Retrospective application in an area that relies on designation by management would not be acceptable, even if an entity applied all other aspects of IFRSs retrospectively.

BC29 The Board found these comments persuasive. In finalising the IFRS, the Board grouped the exceptions to retrospective application into two categories:

- (a) Some exceptions consist of optional exemptions (paragraphs BC30–BC63E).
- (b) The other exceptions prohibit full retrospective application of IFRSs to some aspects of derecognition (paragraphs BC20–BC23), hedge accounting (paragraphs BC75–BC80), and estimates (paragraph BC84).

Exemptions from other IFRSs

BC30 An entity may elect to use one or more of the following exemptions:

- (a) business combinations (paragraphs BC31–BC40);
- (b) deemed cost (paragraphs BC41–BC47E);
- (c) employee benefits (paragraphs BC48–BC52);
- (d) cumulative translation differences (paragraphs BC53–BC55);
- (e) compound financial instruments (paragraphs BC56–BC58);
- (f) investments in subsidiaries, jointly controlled entities* and associates (paragraphs BC58A–BC58M);
- (g) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs BC59–BC63);
- (h) designation of previously recognised financial instruments (paragraph BC63A);
- (i) share-based payment transactions (paragraph BC63B);
- (j) changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment (paragraphs BC63C and BC63CA);
- (k) leases (paragraphs BC63D–BC63DB);
- (l) borrowing costs (paragraph BC63E);
- (m) severe hyperinflation (paragraphs BC63F – BC63J); and
- (n) joint arrangements (paragraphs BC63K and BC63L).

* 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

Business combinations*

- BC31 The following paragraphs discuss various aspects of accounting for business combinations that an entity recognised in accordance with previous GAAP before the date of transition to IFRSs:
- (a) whether retrospective restatement of past business combinations should be prohibited, permitted or required (paragraphs BC32–BC34).
 - (b) whether an entity should recognise assets acquired and liabilities assumed in a past business combination if it did not recognise them in accordance with previous GAAP (paragraph BC35).
 - (c) whether an entity should restate amounts assigned to the assets and liabilities of the combining entities if previous GAAP brought forward unchanged their pre-combination carrying amounts (paragraph BC36).
 - (d) whether an entity should restate goodwill for adjustments made in its opening IFRS balance sheet to the carrying amounts of assets acquired and liabilities assumed in past business combinations (paragraphs BC37–BC40).
- BC32 Retrospective application of IFRS 3 *Business Combinations* could require an entity to recreate data that it did not capture at the date of a past business combination and make subjective estimates about conditions that existed at that date. These factors could reduce the relevance and reliability of the entity's first IFRS financial statements. Therefore, ED 1 would have prohibited restatement of past business combinations (unless an entity used the proposed alternative approach, discussed in paragraph BC15, of applying IFRSs as if it had always applied IFRSs). Some respondents agreed, arguing that restatement of past business combinations would involve subjective, and potentially selective, use of hindsight that would diminish the relevance and reliability of financial statements.
- BC33 Other respondents disagreed. They argued that:
- (a) effects of business combination accounting can last for many years. Previous GAAP may differ significantly from IFRSs, and in some countries there are no accounting requirements at all for business combinations. Previous GAAP balances might not result in decision-useful information in these countries.
 - (b) restatement is preferable and may not involve as much cost or effort for more recent business combinations.
- BC34 In the light of these comments, the Board concluded that restatement of past business combinations is conceptually preferable, although for cost-benefit reasons this should be permitted but not required. The Board decided to place some limits on this election and noted that information is more likely to be available for more recent business combinations. Therefore, if a first-time adopter restates any business combination, the IFRS requires it to restate all later business combinations (paragraph C1 of the IFRS).
- BC35 If an entity did not recognise a particular asset or liability in accordance with previous GAAP at the date of the business combination, ED 1 proposed that its deemed cost in accordance with IFRSs would be zero. As a result, the entity's opening IFRS balance sheet would not have included that asset or liability if IFRSs permit or require a cost-based measurement. Some respondents to ED 1 argued that this would be an unjustifiable departure from the principle that the opening IFRS balance sheet should include all assets and liabilities. The Board agreed with that conclusion. Therefore, paragraph C4(f) of the IFRS requires that the acquirer should

* In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which stated that Appendix C of IFRS 1 should only apply to business combinations within the scope of IFRS 3 *Business Combinations*.

recognise those assets and liabilities and measure them on the basis that IFRSs would require in the separate balance sheet of the acquiree.

BC36 In accordance with previous GAAP, an entity might have brought forward unchanged the pre-combination carrying amounts of the combining entities' assets and liabilities. Some argued that it would be inconsistent to use these carrying amounts as deemed cost in accordance with IFRSs, given that the IFRS does not permit the use of similar carrying amounts as deemed cost for assets and liabilities that were not acquired in a business combination. However, the Board identified no specific form of past business combination, and no specific form of accounting for past business combinations, for which it would not be acceptable to bring forward cost-based measurements made in accordance with previous GAAP.

BC37 Although the IFRS treats amounts assigned in accordance with previous GAAP to goodwill and other assets acquired and liabilities assumed in a past business combination as their deemed cost in accordance with IFRSs at the date of the business combination, an entity needs to adjust their carrying amounts in its opening IFRS balance sheet, as follows.

- (a) Assets and liabilities measured in accordance with IFRSs at fair value* or other forms of current value: remeasure to fair value or that other current value.
- (b) Assets (other than goodwill) and liabilities for which IFRSs apply a cost-based measurement: adjust the accumulated depreciation or amortisation since the date of the business combination if it does not comply with IFRSs. Depreciation is based on deemed cost, which is the carrying amount in accordance with previous GAAP immediately following the business combination.
- (c) Assets (other than goodwill) and liabilities not recognised in accordance with previous GAAP: measure on the basis that IFRSs would require in the separate balance sheet of the acquiree.
- (d) Items that do not qualify for recognition as assets and liabilities in accordance with IFRSs: eliminate from the opening IFRS balance sheet.

BC38 The Board considered whether a first-time adopter should recognise the resulting adjustments by restating goodwill. Because intangible assets and goodwill are closely related, the Board decided that a first-time adopter should restate goodwill when it:

- (a) eliminates an item that was recognised in accordance with previous GAAP as an intangible asset but does not qualify for separate recognition in accordance with IFRSs; or
- (b) recognises an intangible asset that was subsumed within goodwill in accordance with previous GAAP.

However, to avoid costs that would exceed the likely benefits to users, the IFRS prohibits restatement of goodwill for most other adjustments reflected in the opening IFRS balance sheet, unless a first-time adopter elects to apply IFRS 3 retrospectively (paragraph C4(g) of the IFRS).

BC39 To minimise the possibility of double-counting an item that was included in goodwill in accordance with previous GAAP, and is included in accordance with IFRSs either within the measurement of another asset or as a deduction from a liability, the IFRS requires an entity to test goodwill recognised in its opening IFRS balance sheet for impairment (paragraph C4(g)(ii) of the IFRS). This does not prevent the implicit recognition of internally generated goodwill that arose after the date of the business combination. However, the Board concluded that an

* IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

attempt to exclude such internally generated goodwill would be costly and lead to arbitrary results.

- BC40 Some respondents to ED 1 suggested that a formal impairment test should be required only if there is a possibility of double-counting—ie when additional, previously unrecognised, assets relating to a past business combination are recognised in the opening IFRS balance sheet (or an indicator of impairment is present). However, the Board decided that a first-time adopter should carry out a formal impairment test of all goodwill recognised in its opening IFRS balance sheet, as previous GAAP might not have required a test of comparable rigour.

Deemed cost

- BC41 Some measurements in accordance with IFRSs are based on an accumulation of past costs or other transaction data. If an entity has not previously collected the necessary information, collecting or estimating it retrospectively may be costly. To avoid excessive cost, ED 1 proposed that an entity could use the fair value of an item of property, plant and equipment at the date of transition to IFRSs as its deemed cost at that date if determining a cost-based measurement in accordance with IFRSs would involve undue cost or effort.
- BC42 In finalising the IFRS, the Board noted that reconstructed cost data might be less relevant to users, and less reliable, than current fair value data. Furthermore, the Board concluded that balancing costs and benefits was a task for the Board when it sets accounting requirements rather than for entities when they apply those requirements. Therefore, the IFRS permits an entity to use fair value as deemed cost in some cases without any need to demonstrate undue cost or effort.
- BC43 Some expressed concerns that the use of fair value would lead to lack of comparability. However, cost is generally equivalent to fair value at the date of acquisition. Therefore, the use of fair value as the deemed cost of an asset means that an entity will report the same cost data as if it had acquired an asset with the same remaining service potential at the date of transition to IFRSs. If there is any lack of comparability, it arises from the aggregation of costs incurred at different dates, rather than from the targeted use of fair value as deemed cost for some assets. The Board regarded this approach as justified to solve the unique problem of introducing IFRSs in a cost-effective way without damaging transparency.
- BC44 The IFRS restricts the use of fair value as deemed cost to those assets for which reconstructing costs is likely to be of limited benefit to users and particularly onerous: property, plant and equipment, investment property (if an entity elects to use the cost method in IAS 40 *Investment Property*) and intangible assets that meet restrictive criteria (paragraphs D5 and D7 of the IFRS).
- BC45 Under the revaluation model in IAS 16 *Property, Plant and Equipment*, if an entity revalues an asset, it must revalue all assets in that class. This restriction prevents selective revaluation of only those assets whose revaluation would lead to a particular result. Some suggested a similar restriction on the use of fair value as deemed cost. However, IAS 36 *Impairment of Assets* requires an impairment test if there is any indication that an asset is impaired. Thus, if an entity uses fair value as deemed cost for assets whose fair value is above cost, it cannot ignore indications that the recoverable amount of other assets may have fallen below their carrying amount. Therefore, the IFRS does not restrict the use of fair value as deemed cost to entire classes of asset.
- BC46 Some revaluations in accordance with previous GAAP might be more relevant to users than original cost. If so, it would not be reasonable to require time-consuming and expensive reconstruction of a cost that complies with IFRSs. In consequence, the IFRS permits an entity to use amounts determined using previous GAAP as deemed cost for IFRSs in the following cases:
- (a) if an entity revalued one of the assets described in paragraph BC44 using its previous GAAP and the revaluation met specified criteria (paragraphs D6 and D7 of the IFRS).

- (b) if an entity established a deemed cost in accordance with previous GAAP for some or all assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering (paragraph D8 of the IFRS).

BC46A In *Improvements to IFRSs* issued in May 2010, the Board extended the scope of paragraph D8 for the use of the deemed cost exemption for an event-driven fair value. In some jurisdictions, local law requires an entity to revalue its assets and liabilities to fair value for a privatisation or initial public offering (IPO) and to treat the revalued amounts as deemed cost for the entity's previous GAAP. Before the amendment made in May 2010, if that revaluation occurred after the entity's date of transition to IFRSs, the entity could not have used that revaluation as deemed cost for IFRSs. Therefore, the entity would have had to prepare two sets of measurements for its assets and liabilities—one to comply with IFRSs, and one to comply with local law. The Board considered this unduly onerous. Therefore, the Board amended paragraph D8 to allow an entity to recognise an event-driven fair value measurement as deemed cost when the event occurs, provided that this is during the periods covered by its first IFRS financial statements. In addition, the Board concluded that the same relief should apply to an entity that adopted IFRSs in periods before the effective date of IFRS 1 or applied IFRS 1 in a previous period, provided the measurement date is within the period covered by its first IFRS financial statements.

BC46B The Board also decided to require the entity to present historical costs or other amounts already permitted by IFRS 1 for the periods before that date. In this regard, the Board considered an approach where an entity could 'work back' to the deemed cost on the date of transition, using the revaluation amounts obtained on the measurement date, adjusted to exclude any depreciation, amortisation or impairment between the two dates. Although some believed that this presentation would have provided greater comparability throughout the first IFRS reporting period, the Board rejected it because making such adjustments would require hindsight and the computed carrying amounts on the date of transition to IFRSs would be neither the historical costs of the revalued assets nor their fair values on that date.

BC47 Paragraph D6 of the IFRS refers to revaluations that are broadly comparable to fair value or reflect an index applied to a cost that is broadly comparable to cost determined in accordance with IFRSs. It may not always be clear whether a previous revaluation was intended as a measure of fair value or differs materially from fair value. The flexibility in this area permits a cost-effective solution for the unique problem of transition to IFRSs. It allows a first-time adopter to establish a deemed cost using a measurement that is already available and is a reasonable starting point for a cost-based measurement.

BC47A Under their previous GAAP many oil and gas entities accounted for exploration and development costs for properties in development or production in cost centres that include all properties in a large geographical area. (In some jurisdictions, this is referred to as full cost accounting.) Those entities will in most cases have to determine the carrying amounts for oil and gas assets at the date of transition to IFRSs. Information about oil and gas assets recorded in an accounting system using this method of accounting will almost always be at a larger unit of account than the unit of account that is acceptable under IFRSs. Amortisation at the IFRS unit of account level would also have to be calculated (on a unit of production basis) for each year, using a reserves base that has changed over time because of changes in factors such as geological understanding and prices for oil and gas. In many cases, particularly for older assets, this information may not be available. The Board was advised that even if such information is available the effort and associated cost to determine the opening balances at the date of transition would usually be very high.

BC47B IFRS 1 permits an entity to measure an item of property, plant and equipment at its fair value at the date of transition to IFRSs and to use that fair value as the item's deemed cost at that date. Determining the fair value of oil and gas assets is a complex process that begins with the difficult task of estimating the volume of reserves and resources. When the fair value amounts must be audited, determining significant inputs to the estimates generally requires the use of qualified external experts. For entities with many oil and gas assets, the use of this fair value as

deemed cost alternative would not meet the Board's stated intention of avoiding excessive cost (see paragraph BC41).

- BC47C The Board decided that for oil and gas assets in the development or production phases, it would permit entities that used the method of accounting described in paragraph BC47A under their previous GAAP to determine the deemed cost at the date of transition to IFRSs using an allocation of the amount determined for a cost centre under the entity's previous GAAP on the basis of the reserves associated with the oil and gas assets in that cost centre.
- BC47D The deemed cost of oil and gas assets determined in this way may include amounts that would not have been capitalised in accordance with IFRSs, such as some overhead costs, costs that were incurred before the entity obtained legal rights to explore a specific area (and cannot be capitalised in accordance with IAS 38 *Intangible Assets*) and, most significantly, unsuccessful exploration costs. This is a consequence of having included these costs in the single carrying amount under the method of accounting described in paragraph BC47A. To avoid the use of deemed costs resulting in an oil and gas asset being measured at more than its recoverable amount, the Board decided that oil and gas assets should be tested for impairment at the date of transition to IFRSs.
- BC47E Not all oil and gas entities used the method of accounting described in paragraph BC47A under their previous GAAP. Some used a method of accounting that requires a unit of account that is generally consistent with IFRSs and does not cause similar transition issues. Therefore, the Board decided that the exemption would apply only to entities that used the method of accounting described in paragraph BC47A under their previous GAAP.
- BC47F In *Improvements to IFRSs* issued in May 2010, the Board extended the use of the deemed cost exemption to entities with operations subject to rate regulation. An entity might have items of property, plant and equipment or intangible assets that it holds for use in operations subject to rate regulation, or that it once used for this purpose and now holds for other purposes. Under previous GAAP, an entity might have capitalised, as part of the carrying amount of items of property, plant and equipment or intangible assets held for use in operations subject to rate regulation, amounts that do not qualify for capitalisation under IFRSs. For example, when setting rates regulators often permit entities to capitalise, as part of the cost of property, plant and equipment or intangible assets acquired, constructed or produced over time, an allowance for the cost of financing the asset's acquisition, construction or production. This allowance typically includes an imputed cost of equity. IFRSs do not permit an entity to capitalise an imputed cost of equity.
- BC47G Before this amendment, an entity with such items whose carrying amounts include amounts that do not qualify for capitalisation under IFRSs would have had either to restate those items retrospectively to remove the non-qualifying amounts, or to use the exemption in paragraph D5 (fair value as deemed cost). Both of those alternatives pose significant practical challenges, the cost of which can often outweigh the benefit.
- BC47H Typically, once amounts are included in the total cost of an item of property, plant and equipment, they are no longer tracked separately. The restatement of property, plant and equipment to remove amounts not in compliance with IFRSs would require historical information that, given the typical age of some of the assets involved, is probably no longer available and would be difficult to estimate. Obtaining the fair value information necessary to use the exemption in paragraph D5 may not be a practical alternative, given the lack of readily available fair value information for those assets.
- BC47I The Board decided it would permit entities with operations subject to rate regulation to use as deemed cost at the date of transition to IFRSs the carrying amount of the items of property, plant and equipment or intangible assets determined under the entity's previous GAAP. The Board views this exemption as consistent with the exemptions already included in IFRS 1 in that it avoids excessive costs while meeting the objectives of the IFRS.
- BC47J The Board understands that most first-time adopters with operations subject to rate regulation have previously accounted for property, plant and equipment largely in accordance with a

historical cost model consistent with IAS 16. The Board concluded that the cost and effort required to achieve total compliance in this area for the purposes of preparing an entity's first IFRS financial statements is not warranted to meet the objective of providing a suitable starting point for accounting under IFRSs. IFRS 1 requires that each item for which the exemption is used is tested for impairment, either individually or at the cash-generating unit to which the item belongs in accordance with IAS 36, at the date of transition. This requirement provides further assurance that this objective is met.

- BC47K Consistent with the Board's rationale for the use of fair value as deemed cost in paragraphs BC43 and BC44, this exemption means that an entity will report the same cost data as if it had acquired an asset with the same remaining service potential for that amount at the date of transition to IFRSs. An entity's use of this exemption results in a new cost basis for the item and previous GAAP depreciation methods and capitalisation policies are not relevant. Thus, if an entity uses this exemption for items of property, plant and equipment or intangible assets, it does not also apply the exemption for borrowing costs provided in paragraph D23.

Employee benefits

- BC48 [Deleted]
- BC49 The revision of IAS 19 in 1998 increased the reported employee benefit liabilities of some entities. IAS 19 permitted entities to amortise that increase over up to five years. Some suggested a similar transitional treatment for first-time adopters. However, the Board has no general policy of exempting transactions occurring before a specific date from the requirements of new IFRSs (paragraph 21* of the *Preface to International Financial Reporting Standards*). Therefore, the Board did not include a similar transitional provision for first-time adopters.
- BC50 An entity's first IFRS financial statements may reflect measurements of pension liabilities at three dates: the reporting date, the end of the comparative year and the date of transition to IFRSs. Some suggested that obtaining three separate actuarial valuations for a single set of financial statements would be costly. Therefore, they proposed that the Board should permit an entity to use a single actuarial valuation, based, for example, on assumptions valid at the reporting date, with service costs and interest costs based on those assumptions for each of the periods presented.
- BC51 However, the Board concluded that a general exemption from the principle of measurement at each date would conflict with the objective of providing understandable, relevant, reliable and comparable information for users. If an entity obtains a full actuarial valuation at one or two of these dates and rolls that (those) valuation(s) forward or back to the other date(s), any such roll forward or roll back needs to reflect material transactions and other material events (including changes in market prices and interest rates) between those dates (IAS 19 paragraph 57).

- BC52 [Deleted]

Cumulative translation differences

- BC53 IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to classify some cumulative translation differences (CTDs) relating to a net investment in a foreign operation as a separate component of equity. The entity transfers the CTDs to the income statement on subsequent disposal of the foreign operation. The proposals in ED 1 would have permitted a first-time adopter to use the CTDs in accordance with previous GAAP as the deemed CTDs in accordance with IFRSs if reconstructing CTDs would have involved undue cost or effort.
- BC54 Some respondents to ED 1 argued that it would be more transparent and comparable to exempt an entity from the requirement to identify CTDs at the date of transition to IFRSs, for the following reasons:

* amended to paragraph 20 when the *Preface* was revised in January 2010.

- (a) An entity might know the aggregate CTDs, but might not know the amount for each subsidiary. If so, it could not transfer that amount to the income statement on disposal of that subsidiary. This would defeat the objective of identifying CTDs as a separate component of equity.
- (b) The amount of CTDs in accordance with previous GAAP might be inappropriate as it might be affected by adjustments made on transition to IFRSs to assets and liabilities of foreign entities.

BC55 The Board found these arguments persuasive. Therefore, a first-time adopter need not identify the CTDs at the date of transition to IFRSs (paragraphs D12 and D13 of the IFRS). The first-time adopter need not show that identifying the CTDs would involve undue cost or effort.

Compound financial instruments

BC56 IAS 32 requires an entity to split a compound financial instrument at inception into separate liability and equity components. Even if the liability component is no longer outstanding, retrospective application of IAS 32 would involve separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component of the instrument.

BC57 Some respondents to ED 1 argued that separating these two portions would be costly if the liability component of the compound instrument is no longer outstanding at the date of transition to IFRSs. The Board agreed with those comments. Therefore, if the liability component is no longer outstanding at the date of transition to IFRSs, a first-time adopter need not separate the cumulative interest on the liability component from the equity component (paragraph D18 of the IFRS).

BC58 Some respondents requested an exemption for compound instruments even if still outstanding at the date of transition to IFRSs. One possible approach would be to use the fair value of the components at the date of transition to IFRSs as deemed cost. However, as the IFRS does not include any exemptions for financial liabilities, the Board concluded that it would be inconsistent to create such an exemption for the liability component of a compound instrument.

Investments in subsidiaries, jointly controlled entities* and associates

BC58A IAS 27 *Consolidated and Separate Financial Statements* requires an entity, in its separate financial statements, to account for investments in subsidiaries, jointly controlled entities* and associates either at cost or in accordance with IAS 39.[#] For those investments that are measured at cost, the previous version of IAS 27 (before *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* was issued in May 2008) required an entity to recognise income from the investment only to the extent the entity received distributions from post-acquisition retained earnings (the 'cost method'). Distributions received in excess of such profits were regarded as a recovery of investment and were recognised as a reduction in the cost of the investment.

BC58B For some jurisdictions, these aspects of IAS 27 led to practical difficulties on transition to IFRSs. In order to apply IAS 27 retrospectively, it would be necessary:

- (a) to measure the fair value of the consideration given at the date of acquisition; and
- (b) to determine whether any dividends received from a subsidiary after its acquisition were paid out of pre-acquisition retained earnings, which would reduce the carrying

* 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

The consolidation guidance was removed from IAS 27 and the Standard was renamed *Separate Financial Statements* by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The accounting requirements for separate financial statements were not changed.

[∇] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

amount of the investment in the subsidiary in the parent's separate financial statements.

BC58C If a parent held an investment in a subsidiary for many years, such an exercise might be difficult, or even impossible, and perhaps costly. For example, in some jurisdictions, entities accounted for some previous acquisitions that were share-for-share exchanges using so-called 'merger relief' or 'group reconstruction relief'. In this situation, the carrying amount of the investment in the parent's separate financial statements was based on the nominal value of the shares given rather than the value of the purchase consideration. This might make it difficult or impossible to measure the fair value of the shares given.

BC58D The Board published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1, in January 2007. In response to the issues outlined in paragraphs BC58A–BC58C, the Board proposed two exemptions from applying the requirements of IAS 27 retrospectively upon first-time adoption of IFRSs:

- (a) an alternative approach for determining the cost of an investment in a subsidiary in the separate financial statements of a parent; and
- (b) simplification of the process for determining the pre-acquisition retained earnings of that subsidiary.

BC58E In developing that exposure draft, the Board considered three ways of determining a deemed cost of an investment in a subsidiary at the parent's date of transition to IFRSs in its separate financial statements. These were:

- (a) the previous GAAP cost of the investment (previous GAAP deemed cost).
- (b) the parent's interest in the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's statement of financial position (net asset deemed cost).
- (c) the fair value of the investment (fair value deemed cost).

BC58F The Board decided that the net asset deemed cost option would provide relevant information to users about the subsidiary's financial position at the date of transition to IFRSs and would be relatively easy to determine. The fair value deemed cost option would provide relevant information at the date of transition to IFRSs, but might be more costly and difficult to determine.

BC58G In some situations, the cost of an investment in a subsidiary determined using the previous GAAP carrying amount might bear little resemblance to cost determined in accordance with IAS 27. Therefore, the Board rejected the use of a deemed cost based on the previous GAAP carrying amount. The Board proposed to allow entities a choice between the net asset deemed cost and the fair value deemed cost.

BC58H Respondents to the exposure draft stated that the previous GAAP carrying amount is a more appropriate deemed cost. They argued that:

- (a) a net asset deemed cost would not include goodwill or other intangible assets that might be present in a carrying amount determined in accordance with previous GAAP. When this is the case, the net asset deemed cost option would understate the assets of the entities for which it is used. The resulting reduction in the carrying amount of the investment could reduce the distributable profits of the parent.
- (b) it was difficult to see why, in the light of the exemption in IFRS 1 from applying IFRS 3 retrospectively, the Board did not propose to permit the cost of the investment in a subsidiary in accordance with previous GAAP to be used as a deemed cost. When an entity had chosen not to apply IFRS 3 retrospectively to a past business combination,

it would be logical not to require it to restate the cost of the related investment in the separate financial statements of the parent.

- BC58I In the light of respondents' comments, the Board observed that, in many instances, neither the previous GAAP carrying amount nor the net asset deemed cost represents 'cost'—both numbers could be viewed as being equally arbitrary.
- BC58J In order to reduce the cost of adopting IFRSs in the parent entity's separate financial statements without significantly reducing the benefits of those statements, the Board decided to allow entities a choice between the previous GAAP carrying amount and the fair value as deemed cost.
- BC58K The Board also agreed with respondents that similar issues arise for investments in associates and jointly controlled entities.[†] As a result, paragraph D15 of the IFRS applies to such investments.
- BC58L The Board published its revised proposals in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*, an exposure draft of proposed amendments to IFRS 1 and IAS 27, in December 2007. Respondents generally supported the proposed amendments to IFRS 1. The Board included the amendments in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* issued in May 2008.
- BC58M In developing the December 2007 exposure draft, the Board decided to address the simplification of the process for determining the pre-acquisition retained earnings of a subsidiary more generally through an amendment to IAS 27 (see paragraph 38A of IAS 27 and paragraphs BC66D–BC66J[#] of the Basis for Conclusions on IAS 27).

Assets and liabilities of subsidiaries, associates and joint ventures

- BC59 A subsidiary may have reported to its parent in the previous period using IFRSs without presenting a full set of financial statements in accordance with IFRSs. If the subsidiary subsequently begins to present financial statements that contain an explicit and unreserved statement of compliance with IFRSs, it becomes a first-time adopter at that time. This might compel the subsidiary to keep two parallel sets of accounting records based on different dates of transition to IFRSs, because some measurements in accordance with the IFRS depend on the date of transition to IFRSs.
- BC60 In developing ED 1, the Board concluded that a requirement to keep two parallel sets of records would be burdensome and not be beneficial to users. Therefore, ED 1 proposed that a subsidiary would not be treated as a first-time adopter for recognition and measurement purposes if the subsidiary was consolidated in IFRS financial statements for the previous period and all owners of the minority interests consented.*
- BC61 Some respondents to ED 1 opposed the exemption, on the following grounds:
- (a) The exemption would not eliminate all differences between the group reporting package and the subsidiary's own financial statements. The reporting package does not constitute a full set of financial statements, the parent may have made adjustments to the reported numbers (for example, if pension cost adjustments were made centrally), and the group materiality threshold may be higher than for the subsidiary.

[†] 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

[#] renumbered to paragraphs 12 and BC16-BC22 when IAS 27 was amended in May 2011.

* In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended 'minority interests' to 'non-controlling interests'. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The term 'non-controlling interests' and the requirements for non-controlling interests were not changed.

- (b) The Board's objective of comparability between different entities adopting IFRSs for the first time at the same date (paragraph BC10) should apply equally to any entity, including subsidiaries, particularly if the subsidiary's debt or equity securities are publicly traded.

BC62 However, the Board retained the exemption because it will ease some practical problems. Although the exemption does not eliminate all differences between the subsidiary's financial statements and a group reporting package, it does reduce them. Furthermore, the exemption does not diminish the relevance and reliability of the subsidiary's financial statements because it permits a measurement that is already acceptable in accordance with IFRSs in the consolidated financial statements of the parent. Therefore, the Board also eliminated the proposal in ED 1 that the exemption should be conditional on the consent of minorities.

BC63 In finalising the IFRS, the Board simplified the description of the exemption for a subsidiary that adopts IFRSs after its parent. In accordance with the IFRS, the subsidiary may measure its assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary.* Alternatively, it may elect to measure them at the carrying amounts required by the rest of the IFRS, based on the subsidiary's date of transition to IFRSs. The Board also extended the exemption to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it (paragraph D16 of the IFRS). However, if a parent adopts IFRSs later than a subsidiary, the parent cannot, in its consolidated financial statements, elect to change IFRS measurements that the subsidiary has already used in its financial statements, except to adjust for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary[‡] (paragraph D17 of the IFRS).

Designation of previously recognised financial instruments

BC63A IAS 39[∇] permits an entity to designate, on initial recognition only, a financial instrument as (a) available for sale[±] (for a financial asset) or (b) a financial asset or financial liability at fair value through profit or loss (provided the asset or liability qualifies for such designation in accordance with paragraph 9(b)(i), 9(b)(ii) ~~or 11A of IAS 39~~). Despite this requirement, an entity that had already applied IFRSs before the effective date of IAS 39 (as revised in March 2004) may (a) designate a previously recognised financial asset as available for sale on initial application of IAS 39 (as revised in March 2004), or (b) designate a previously recognised financial instrument as at fair value through profit or loss in the circumstances specified in paragraph 105B of IAS 39. The Board decided that the same considerations apply to first-time adopters as to entities that already apply IFRSs. Accordingly, a first-time adopter of IFRSs may similarly designate a previously recognised financial instrument in accordance with paragraph D19 of the IFRS. Such an entity shall disclose the fair value of the financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

* In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which removed option D16(a) for investments in subsidiaries of investment entities, as defined in IFRS 10 *Consolidated Financial Statements*, required to be measured at fair value through profit or loss.

[‡] In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which amended paragraph D17 to clarify its application to investment entities, as defined in IFRS 10.

[∇] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

[±] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

Share-based payment transactions

BC63B IFRS 2 *Share-based Payment* contains various transitional provisions. For example, for equity-settled share-based payment arrangements, IFRS 2 requires an entity to apply IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not vested at the effective date of IFRS 2. IFRS 2 is effective for annual periods beginning on or after 1 January 2005. There are also transitional arrangements for liabilities arising from cash-settled share-based payment transactions, and for modifications of the terms or conditions of a grant of equity instruments to which IFRS 2 has not been applied, if the modification occurs after the effective date of IFRS 2. The Board decided that, in general, first-time adopters should be treated in the same way as entities that already apply IFRSs. For example, a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted on or before 7 November 2002. Similarly, a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted after 7 November 2002 if those equity instruments vested before 1 January 2005. In addition, the Board decided that a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted after 7 November 2002 if those equity instruments vested before the date of transition to IFRSs. Similarly, the Board decided that a first-time adopter should not be required to apply IFRS 2 to liabilities arising from cash-settled share-based payment transactions if those liabilities were settled before the date of transition to IFRSs.

Changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment

BC63C IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in decommissioning, restoration and similar liabilities to be added to, or deducted from, the cost of the assets to which they relate, and the adjusted depreciable amount to be depreciated prospectively over the remaining useful life of those assets. Retrospective application of this requirement at the date of transition would require an entity to construct a historical record of all such adjustments that would have been made in the past. In many cases this will not be practicable. The Board agreed that, as an alternative to complying with this requirement, an entity should be permitted to include in the depreciated cost of the asset, at the date of transition to IFRSs, an amount calculated by discounting the liability at that date back to, and depreciating it from, when the liability was first incurred.

BC63C A Paragraph D21 of the IFRS exempts from the requirements of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* changes in decommissioning costs incurred before the date of transition to IFRSs. Use of this exemption would require detailed calculations that would not be practicable for entities that used the method of accounting described in paragraph BC47A under their previous GAAP. The Board noted that adjustments to liabilities as a result of initial adoption of IFRSs arise from events and transactions before the date of transition to IFRSs and are generally recognised in retained earnings. Therefore, the Board decided that, for entities that used the method of accounting described in paragraph BC47A, any adjustment for a difference between decommissioning, restoration and similar liabilities measured in accordance with IAS 37 and the liability determined under the entity's previous GAAP should be accounted for in the same manner.

Leases

BC63D IFRIC 4 *Determining whether an Arrangement contains a Lease* contains transitional provisions because the IFRIC acknowledged the practical difficulties raised by full retrospective application of the Interpretation, in particular the difficulty of going back potentially many years and making a meaningful assessment of whether the arrangement satisfied the criteria at that time. The Board decided to treat first-time adopters in the same way as entities that already apply IFRSs.

BC63DA IFRIC 4 permits an entity to apply its requirements to arrangements existing at the start of the earliest period for which comparative information is presented on the basis of facts and circumstances existing at the start of that period. Before adopting IFRSs, a jurisdiction might adopt a national standard having the same effect as the requirements of IFRIC 4, including the same transitional provisions. An entity in that jurisdiction might then apply requirements having the same effect as the requirements of IFRIC 4 to some or all arrangements (even if the wording of those requirements is not identical). However, the entity might apply the requirements at a date different from the date in the transitional provisions of IFRIC 4. IFRS 1 would require such an entity to reassess that accounting retrospectively on first-time adoption. This might result in additional costs, with no obvious benefits. Accordingly, the Board decided that if a first-time adopter made the same determination under previous GAAP as that required by IFRIC 4 but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRSs.

BC63DB The Board considered a more general modification to IFRS 1. It considered whether to modify IFRS 1 so that entities need not reassess, at the date of transition to IFRSs, prior accounting if that prior accounting permitted the same prospective application as IFRSs with the only difference from IFRSs being the effective date from when that accounting was applied. In this regard, the Board noted that any such proposal must apply to assessments resulting in the *same* determination, rather than *similar* determinations, because it would be too difficult to determine and enforce what constitutes a sufficient degree of similarity. The Board noted that many of the circumstances in which this situation might arise have been dealt with in IFRS 1 or other IFRSs. Accordingly, the Board decided to focus on IFRIC 4 only.

Borrowing costs

BC63E IAS 23 *Borrowing Costs* (as revised in 2007) contains transitional provisions because the Board acknowledged that if an entity has been following the accounting policy of immediately recognising borrowing costs as an expense and has not previously gathered the necessary information for capitalisation of borrowing costs, getting the information retrospectively may be costly. First-time adopters of IFRSs face problems similar to those facing entities that already apply IFRSs. Moreover, although first-time adopters have the option of using fair value as the deemed cost of an asset at the date of transition to IFRSs, this option is not applicable to all qualifying assets, such as inventories. Furthermore, the Board concluded that the existence of the deemed cost option is not sufficient to justify a more stringent requirement for the application of IAS 23 for first-time adopters than for entities that already apply IFRSs. A more stringent requirement for the adoption of the capitalisation treatment could be justified when IFRS 1 was originally issued because capitalisation was then an option. The requirements for the application of mandatory capitalisation, on the other hand, should be the same for entities that already apply IFRSs and for first-time adopters. Therefore, the Board decided to amend IFRS 1, allowing first-time adopters transitional provisions equivalent to those available to entities that already apply IFRSs in paragraphs 27 and 28 of IAS 23, as revised in 2007.

BC63EA In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed some concerns that were raised by first-time adopters about the transitional provisions for borrowing costs relating to qualifying assets for which the commencement date for capitalisation was before the date of transition to IFRSs. Interested parties found it unclear whether borrowing costs capitalised in accordance with previous GAAP should be retained, restated or eliminated in the opening statement of financial position. Interested parties also questioned the accounting, after the date of transition, for borrowing costs that relate to such qualifying assets when these qualifying assets are under construction at the date of transition. They wanted clarification as to whether the first-time adopter should apply the requirements of IAS 23 *Borrowing Costs* or whether it should continue applying its previous GAAP even if that previous GAAP is not consistent with IAS 23.

BC63EB The Board clarified that when the entity chooses to apply the exemption in paragraph D23 of IFRS 1, the borrowing costs that were capitalised in accordance with previous GAAP should be carried forward in the opening statement of financial position. This is because gathering the information for capitalisation of borrowing costs under IAS 23 and identifying and

eliminating the amounts (if any) capitalised in past years under previous GAAP may be costly. In addition, the Board clarified that an entity should account for borrowing costs that are incurred after the date of transition and that relate to qualifying assets under construction at the date of transition in accordance with IAS 23, regardless of whether the entity capitalised or recognised in profit and loss borrowing costs under previous GAAP. The Board determined that this requirement would ensure useful information to users of financial statements. A first-time adopter could also choose to apply the requirements of IAS 23 from a date earlier than the date of transition, in which case it should account for borrowing costs in accordance with IAS 23 on or after the earlier date selected.

Severe hyperinflation

- BC63F In 2010 the Board was asked to clarify how an entity should resume presenting financial statements in accordance with IFRSs after a period of severe hyperinflation, during which the entity had been unable to comply with IAS 29 *Financial Reporting in Hyperinflationary Economies*. An entity would be unable to comply with IAS 29 if a reliable general price index is not available to all entities with that same functional currency, and exchangeability between the currency and a relatively stable foreign currency does not exist. However, once the functional currency changes to a non-hyperinflationary currency, or the currency ceases to be severely hyperinflationary, an entity would be able to start applying IFRSs to subsequent transactions.
- BC63G The Board noted that IFRSs did not provide sufficient guidance in these circumstances. The Board therefore decided to amend IFRS 1 to provide guidance on how an entity can present IFRS financial statements after its currency ceases to be severely hyperinflationary, by presenting an opening IFRS statement of financial position on or after the functional currency normalisation date. The Board believed that allowing an entity to apply the exemption when presenting an opening IFRS statement of financial position after, and not just on, the functional currency normalisation date, would address practical concerns that may arise if the functional currency normalisation date and the entity's date of transition to IFRSs are different. The Board decided that this amendment would also be available to entities that were emerging from a period of severe hyperinflation but had not applied IFRSs in the past.
- BC63H The Board decided to permit an entity emerging from a period of severe hyperinflation to elect to measure its assets and liabilities at fair value. That fair value could then be used as the deemed cost in its opening IFRS statement of financial position. The Board believed that this approach would expand the scope of the deemed cost exemptions in IFRS 1 to enable them to be applied in these specific circumstances. However, because severe hyperinflation is a specific set of circumstances, the Board wanted to ensure that the fair value measurement option was applied only to those assets and liabilities that were held before the functional currency normalisation date, and not to other assets and liabilities held by the entity at the time it made the transition to IFRSs. Furthermore, where a parent entity's functional currency has been subject to severe hyperinflation, but its subsidiary company's functional currency has not been subject to severe hyperinflation, the Board decided it was inappropriate for such a subsidiary company to be able to apply this exemption.
- BC63I The Board decided that any adjustments arising on electing to measure assets and liabilities at fair value in the opening IFRS statement of financial position arise from events and transactions before the date of transition to IFRSs. Consequently, those adjustments should be accounted for in accordance with paragraph 11 of IFRS 1, and an entity should recognise those adjustments directly in retained earnings (or, if appropriate, in another category of equity) at the date of transition to IFRSs.
- BC63J The Board observed that entities are required to apply paragraph 21 of IFRS 1 and prepare and present comparative information in accordance with IFRSs. The Board noted that preparation of information in accordance with IFRSs for periods before the functional currency normalisation date may not be possible; hence the exemption refers to a date of transition on or after the functional currency normalisation date. This may lead to a comparative period of less than 12 months. The Board identified that entities should consider whether disclosure of non-IFRS comparative information and historical summaries, in accordance with paragraph

22 of IFRS 1, would provide useful information to users of financial statements. The Board also noted that an entity should clearly explain the transition to IFRSs in accordance with paragraphs 23–28.

Joint arrangements

- BC63K During its redeliberation of the exposure draft ED 9 *Joint Arrangements* the Board decided not to require entities changing from proportionate consolidation to the equity method to adjust any differences between the two accounting methods retrospectively. Instead an entity should determine the opening balance of the investment relating to its interest in a joint venture as the aggregate of the carrying amounts of the assets and liabilities that the entity had been previously proportionately consolidated, including any goodwill arising from acquisition as at the beginning of the earliest period presented. The Board decided to treat first-time adopters in the same way as entities that already apply IFRSs with the following exception.
- BC63L A first-time adopter is required to test for impairment the opening investment in accordance with IAS 36 at the earliest period presented, regardless of whether there is any indication that the investment may be impaired. The Board noted that this is a more stringent requirement for the application of IFRS 11 *Joint Arrangements* by first-time adopters, but is aligned with the requirement for first-time adopters to apply IAS 36 in testing goodwill for impairment at the date of transition to IFRSs regardless of whether there is any indication that the goodwill may be impaired.
- BC63M *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to IFRS 10, IFRS 11 and IFRS 12), issued in June 2012, amended IFRS 11 to require the transition adjustments of that IFRS to be recognised at the beginning of the annual period immediately preceding the first annual period for which IFRS 11 is applied (the ‘immediately preceding period’) instead of the beginning of the earliest period presented. The Board agreed that IFRS 1 should not be amended to reflect those amendments because the adjustments required on transition to IFRS should be reflected at the date of transition, which may be earlier than the beginning of the immediately preceding period. Consequently, paragraph D31 was amended to clarify that, when a first-time adopter is applying the transition guidance of IFRS 11, they shall apply the requirements at the date of transition, which is the same as the beginning of the earliest IFRS period presented.

Other possible exemptions rejected

- BC64 The Board considered and rejected suggestions for other exemptions. Each such exemption would have moved the IFRS away from a principle-based approach, diminished transparency for users, decreased comparability over time within an entity’s first IFRS financial statements and created additional complexity. In the Board’s view, any cost savings generated would not have outweighed these disadvantages. Paragraphs BC65–BC73 discuss some of the specific suggestions the Board considered for embedded derivatives, hyperinflation, intangible assets and transaction costs on financial instruments.

Embedded derivatives

- BC65 IAS 39* requires an entity to account separately for some embedded derivatives at fair value. Some respondents to ED 1 argued that retrospective application of this requirement would be costly. Some suggested either an exemption from retrospective application of this requirement, or a requirement or option to use the fair value of the host instrument at the date of transition to IFRSs as its deemed cost at that date.

* The Board amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

- BC66 The Board noted that US GAAP provides an option in this area. Under the transitional provisions of SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*, an entity need not account separately for some pre-existing embedded derivatives. Nevertheless, the Board concluded that the failure to measure embedded derivatives at fair value would diminish the relevance and reliability of an entity's first IFRS financial statements. The Board also observed that IAS 39 addresses an inability to measure an embedded derivative and the host contract separately. In such cases, IAS 39 requires an entity to measure the entire combined contract at fair value.

Hyperinflation

- BC67 Some argued that the cost of restating financial statements for the effects of hyperinflation in periods before the date of transition to IFRSs would exceed the benefits, particularly if the currency is no longer hyperinflationary. However, the Board concluded that such restatement should be required, because hyperinflation can make unadjusted financial statements meaningless or misleading.

Intangible assets

- BC68 For the following reasons, some proposed that a first-time adopter's opening IFRS balance sheet should exclude intangible assets that it did not recognise in accordance with previous GAAP:
- (a) Using hindsight to assess retrospectively when the recognition criteria for intangible assets were met could be subjective, open up possibilities for manipulation and involve costs that might exceed the benefits to users.
 - (b) The benefits expected from intangible assets are often not related directly to the costs incurred. Therefore, capitalising the costs incurred is of limited benefit to users, particularly if the costs were incurred in the distant past.
 - (c) Such an exclusion would be consistent with the transitional provisions in IAS 38 *Intangible Assets*. These encourage (but do not require) the recognition of intangible assets acquired in a previous business combination that was an acquisition and prohibit the recognition of all other previously unrecognised intangible assets.
- BC69 In many cases, internally generated intangible assets do not qualify for recognition in accordance with IAS 38 at the date of transition to IFRSs because an entity did not, in accordance with previous GAAP, accumulate cost information or did not carry out contemporaneous assessments of future economic benefits. In these cases, there is no need for a specific requirement to exclude those assets. Furthermore, when these assets do not qualify for recognition, first-time adopters will not generally, in the Board's view, need to perform extensive work to reach this conclusion.
- BC70 In other cases, an entity may have accumulated and retained sufficient information about costs and future economic benefits to determine which intangible assets (whether internally generated or acquired in a business combination or separately) qualify in accordance with IAS 38 for recognition in its opening IFRS balance sheet. If that information is available, no exclusion is justified.
- BC71 Some argued that fair value should be used as deemed cost for intangible assets in the opening IFRS balance sheet (by analogy with a business combination). ED 1 would not have permitted this. However, in finalising the IFRS, the Board concluded that this approach should be available for those intangible assets for which IFRSs already permit fair value measurements. Therefore, in accordance with the IFRS, a first-time adopter may elect to use fair value or some previous GAAP revaluations of intangible assets as deemed cost for IFRSs, but only if the intangible assets meet:

- (a) the recognition criteria in IAS 38 (including reliable measurement of original cost); and
- (b) the criteria in IAS 38 for revaluation (including the existence of an active market) (paragraph D7 of the IFRS).

Transaction costs: financial instruments

BC72 To determine the amortised cost of a financial asset or financial liability using the effective interest method, it is necessary to determine the transaction costs incurred when the asset or liability was originated. Some respondents to ED 1 argued that determining these transaction costs could involve undue cost or effort for financial assets or financial liabilities originated long before the date of transition to IFRSs. They suggested that the Board should permit a first-time adopter:

- (a) to use the fair value of the financial asset or financial liability at the date of transition to IFRSs as its deemed cost at that date; or
- (b) to determine amortised cost without considering transaction costs.

BC73 In the Board's view, the unamortised portion of transaction costs at the date of transition to IFRSs is unlikely to be material for most financial assets and financial liabilities. Even when the unamortised portion is material, reasonable estimates should be possible. Therefore, the Board created no exemption in this area.

Retrospective designation

BC74 The Board considered practical implementation difficulties that could arise from the retrospective application of aspects of IAS 39:^{*}

- (a) hedge accounting (paragraphs BC75–BC80);
- (b) government loans (paragraphs BC80A–BC80E);
- (c) the treatment of cumulative fair value changes on available-for-sale financial assets[#] at the date of transition to IFRSs (paragraphs BC81–BC83); and
- (d) 'day 1' gain or loss recognition (paragraph BC83A).

Hedge accounting[∇]

BC75 Before beginning their preparations for adopting IAS 39 (or a local standard based on IAS 39), it is unlikely that most entities would have adopted IAS 39's criteria for (a) documenting hedges at their inception and (b) testing the hedges for effectiveness, even if they intended to continue the same hedging strategies after adopting IAS 39. Furthermore, retrospective designation of hedges (or retrospective reversal of their designation) could lead to selective designation of some hedges to report a particular result.

BC76 To overcome these problems, the transitional requirements in IAS 39 require an entity already applying IFRSs to apply the hedging requirements prospectively when it adopts IAS 39. As the same problems arise for a first-time adopter, the IFRS requires prospective application by a first-time adopter.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

[#] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

[∇] IFRS 9 *Financial Instruments* replaced the hedge accounting requirements in IAS 39.

- BC77 ED 1 included a redrafted version of the transitional provisions in IAS 39 and related *Questions and Answers* (Q&As) developed by the IAS 39 Implementation Guidance Committee. The Board confirmed in the Basis for Conclusions published with ED 1 that it did not intend the redrafting to create substantive changes. However, in the light of responses to ED 1, the Board decided in finalising IFRS 1 that the redrafting would not make it easier for first-time adopters and others to understand and apply the transitional provisions and Q&As. However, the project to improve IAS 32 and IAS 39 resulted in certain amendments to the transition requirements. In addition, this project incorporated selected other Q&As (ie not on transition) into IAS 39. The Board therefore took this opportunity to consolidate all the guidance for first-time adopters in one place, by incorporating the Q&As on transition into IFRS 1.
- BC78 Some respondents to ED 1 asked the Board to clarify what would happen if hedge accounting in accordance with previous GAAP involved hedging relationships of a type that does not qualify for hedge accounting in accordance with IAS 39. The problem can be seen most clearly for a hedge of a net position (macro hedge). If a first-time adopter were to use hedge accounting in its opening IFRS balance sheet for a hedge of a net position, this would involve either:
- (a) recognising deferred debits and credits that are not assets and liabilities (for a fair value hedge); or
 - (b) deferring gains or losses in equity when there is, at best, a weak link to an underlying item that defines when they should be transferred to the income statement (for a cash flow hedge).
- BC79 As either of these treatments would diminish the relevance and reliability of an entity's first IFRS financial statements, the Board decided that an entity should not apply hedge accounting in its opening IFRS balance sheet to a hedge of a net position that does not qualify as a hedged item in accordance with IAS 39. However, the Board concluded that it would be reasonable (and consistent with IAS 39 paragraph 133^{*}) to permit a first-time adopter to designate an individual item as a hedged item within the net position, provided that it does so no later than the date of transition to IFRSs, to prevent selective designation. For similar reasons, the Board prohibited hedge accounting in the opening IFRS balance sheet for any hedging relationship of a type that does not qualify for hedge accounting in accordance with IAS 39 (see paragraph B5 of the IFRS).
- BC80 Some respondents to ED 1 suggested that an entity adopting IFRSs for the first time in 2005 could not meet IAS 39's documentation and effectiveness criteria by the date of transition to IFRSs (1 January 2004 for many entities). Some requested an exemption from these criteria until the beginning of the latest period covered by the first IFRS financial statements (1 January 2005 for many entities). However, for the following reasons, the Board did not create an exemption in this area:
- (a) The Board's primary objective is comparability within a first-time adopter's first IFRS financial statements and between different first-time adopters switching to IFRSs at the same time (paragraph BC10).
 - (b) The continuation of previous GAAP hedge accounting practices could permit the non-recognition of derivatives or the recognition of deferred debits and credits that are not assets and liabilities.
 - (c) The Board's benchmark for cost-benefit assessments was an entity that has planned the transition to IFRSs and is able to collect the necessary information at, or very soon after, the date of transition to IFRSs (paragraph BC27). Entities should not be 'rewarded' by concessions if they failed to plan for transition, nor should that failure be allowed to undermine the integrity of their opening IFRS balance sheet. Entities

* In IAS 39, as revised in 2003, paragraph 133 was replaced by paragraphs 84 and AG101.

switching to IFRSs in 2005 need to have their hedge accounting systems in place by the beginning of 2004. In the Board's view, that is a challenging but achievable timetable. Entities preparing to switch to IFRSs in 2004 should have been aware of the implications of IAS 39 already and the exposure draft of improvements to IAS 39, published in June 2002, proposed very few changes in this area, so delayed transition is not justified for these entities either.

Government loans

- BC80A IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (as revised in May 2008) introduced a requirement that government loans with a below-market rate of interest shall be measured at fair value on initial recognition. At the time this requirement was added, the Board recognised that applying it retrospectively may require entities to measure the fair value of loans at an earlier date. Accordingly, the Board decided that entities should apply this requirement in IAS 20 prospectively, with earlier application permitted.
- BC80B In 2011 the application of this requirement by first-time adopters was brought to the Board's attention. The Board noted that the general requirement in IFRS 1 for first-time adopters to apply IFRSs retrospectively at the date of transition to IFRSs could require some entities to measure such government loans at fair value at a date before the date of transition to IFRSs. This may lead to an entity applying hindsight if it must derive a fair value that needs significant unobservable inputs. Accordingly, the Board decided to add an exception to the retrospective application of IFRSs to require that first-time adopters shall apply the requirements of IAS 20 prospectively to government loans existing at the date of transition to IFRSs, unless the necessary information was obtained at the time of initially accounting for that loan. As a result of not applying IAS 20 and IFRS 9 retrospectively to government loans at the date of transition, the corresponding benefit of the government loan at a below-market rate of interest is not recognised as a government grant.
- BC80C The Board proposed the exception in October 2011 in the exposure draft *Government Loans* (proposed amendments to IFRS 1). In recognition of comments on the exposure draft, the Board revised paragraph B10 to specify that an entity applies IAS 32 *Financial Instruments: Presentation* to classify the government loans as a financial liability or an equity instrument, and to limit the scope of the exemption to matters of recognition and measurement. This will give first-time adopters the same relief as existing preparers and will mean that if a first-time adopter had classified government loans in equity under its previous GAAP, it will reclassify those loans as liabilities, if those loans meet the definition of a financial liability in IAS 32. The Board also clarified that an entity should use its previous GAAP carrying amount of such loans at the date of transition to IFRSs as the carrying amount in the opening IFRS statement of financial position. IFRS 9 should be applied to such loans subsequently.
- BC80D Some respondents to the exposure draft asked why the retrospective application of IAS 20 should be optional, rather than mandatory, if the information needed to apply IFRS 9 had been obtained. The Board thought that mandatory restatement could require an onerous search to determine whether this information had been obtained when initially accounting for loans that were received many years ago.
- BC80E The Board noted that prohibiting the application of this option on a loan-by-loan basis might introduce further complexity into IFRS 1. This is because it may raise further questions, such as whether the retrospective application would be permitted for all the loans for which the information needed was obtained at the time, even if there are other similar loans for which the fair value information was not obtained at that time; and whether the retrospective application should be restricted to all loans received after a certain date and for which all necessary information was obtained to enable retrospective application. The Board concluded that the exception proposed in paragraph B11 should be available on a loan-by-loan basis.

BC80F In November 2013 the Board amended the examples in the guidance on hedge accounting so that they conformed to IFRS 9, which replaced the hedge accounting requirements in IAS 39.

Available-for-sale financial assets[#]

- BC81 Retrospective application of IAS 39^{*} to available-for-sale financial assets requires a first-time adopter to recognise the cumulative fair value changes in a separate component of equity in the opening IFRS balance sheet, and transfer those fair value changes to the income statement on subsequent disposal or impairment of the asset. This could allow, for example, selective classification of assets with cumulative gains as available for sale (with subsequent transfers to the income statement on disposal) and assets with cumulative losses as held for trading (with no transfers on disposal).
- BC82 IAS 39 confirmed the proposal in the exposure draft of June 2002 to give an entity that already applies IFRSs an option to designate any financial asset as at fair value through profit or loss when it first applies the proposed improvements. Although this requirement could increase the risk of selective classification by first-time adopters of the kind discussed in the previous paragraph, the Board noted that an entity could achieve a similar result by selective disposal of some assets before the date of transition to IFRSs. Therefore, the Board concluded that it should treat first-time adopters in the same way as entities that already apply IFRSs by requiring retrospective application.
- BC83 Some respondents to ED 1 commented that the cost of determining the amount to be included in a separate component of equity would exceed the benefits. However, the Board noted that these costs would be minimal if a first-time adopter carried the available-for-sale financial assets in accordance with previous GAAP at cost or the lower of cost and market value. These costs might be more significant if it carried them at fair value, but in that case it might well classify the assets as held for trading. Therefore, the Board made no changes to ED 1's proposal that a first-time adopter should apply IAS 39 retrospectively to available-for-sale financial assets.
- BC83A IFRS 1 originally required retrospective application of the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76. After the revised IAS 39 was issued, constituents raised concerns that retrospective application would diverge from the requirements of US GAAP, would be difficult and expensive to implement, and might require subjective assumptions about what was observable and what was not. In response to these concerns, the Board decided to permit entities to apply the requirements in the last sentence of IAS 39 paragraph AG76 and in paragraph AG76A, in any one of the following ways:
- (a) retrospectively;
 - (b) prospectively to transactions entered into after 25 October 2002; or
 - (c) prospectively to transactions entered into after 1 January 2004.

In 2010 the Board was asked to reconsider whether the fixed dates of 25 October 2002 and 1 January 2004 continued to be appropriate for first-time adopters. Constituents were concerned that, as time passes, these fixed dates become more remote and increasingly less relevant to the financial reports as additional jurisdictions adopt IFRSs. The Board accepted that the cost of reconstructing transactions back in time to 25 October 2002 or 1 January 2004 was likely to outweigh the benefit to be achieved in doing so. It therefore amended the fixed dates included in paragraph D20 of IFRS 1 to permit a first-time adopter to apply the 'day 1' gain or loss recognition requirement in IAS 39 paragraphs AG76 and AG76A prospectively from 'the date of transition to IFRSs'.[∇]

[#] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

[∇] IFRS 9 *Financial Instruments* replaced IAS 39. Paragraphs AG76 and AG76A of IAS 39 were relocated to IFRS 9 as paragraphs B5.4.8 and B5.4.9. However, in May 2011, IFRS 13 deleted paragraphs B5.4.8 and B5.4.9 of IFRS 9. In 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraphs B5.4.8 and B5.4.9 of IFRS 9 now contains requirements related to amortised cost measurement.

Estimates

- BC84 An entity will have made estimates in accordance with previous GAAP at the date of transition to IFRSs. Events between that date and the reporting date for the entity's first IFRS financial statements might suggest a need to change those estimates. Some of those events might qualify as adjusting events in accordance with IAS 10 *Events after the Balance Sheet Date*.^{*} However, if the entity made those estimates on a basis consistent with IFRSs, the Board concluded that it would be more helpful to users—and more consistent with IAS 8—to recognise the revision of those estimates as income or expense in the period when the entity made the revision, rather than in preparing the opening IFRS balance sheet (paragraphs 14–17 of the IFRS).

Presentation and disclosure

Comparative information

- BC85 IAS 1 requires an entity to disclose comparative information (in accordance with IFRSs) for the previous period. Some suggested that a first-time adopter should disclose comparative information for more than one previous period. For entities that already apply IFRSs, users normally have access to financial statements prepared on a comparable basis for several years. However, this is not the case for a first-time adopter.
- BC86 Nevertheless, the Board did not require a first-time adopter to present more comparative information than IAS 1 requires, because such a requirement would impose costs out of proportion to the benefits to users, and increase the risk that preparers might need to make arbitrary assumptions in applying hindsight.
- BC87 ED 1 proposed that if the first IFRS financial statements include more than one year of comparative information, the additional comparative information should comply with IFRSs. Some respondents to ED 1 noted that some regulators require entities to prepare more than two years of comparatives. They argued the following:
- (a) A requirement to restate two years of comparatives would impose excessive costs and lead to arbitrary restatements that might be biased by hindsight.
 - (b) Consider an entity adopting IFRSs in 2005 and required by its regulator to give two years of comparatives. Its date of transition to IFRSs would be 1 January 2003—several months before the publication of the IFRS and of the standards resulting from the improvements project. This could contradict the Board's assertion in paragraph BC27 above that most preparers could gather most information they need for their opening IFRS balance sheet at, or soon after, the date of transition to IFRSs.
- BC88 In response to these comments, the Board deleted this proposal. Instead, if a first-time adopter elects to give more than one year of comparative information, the additional comparative information need not comply with IFRSs, but the IFRS requires the entity:
- (a) to label previous GAAP information prominently as not being prepared in accordance with IFRSs.
 - (b) to disclose the nature of the main adjustments that would make it comply with IFRSs (paragraph 22 of the IFRS).

^{*} In September 2007 the IASB amended the title of IAS 10 *Events after the Balance Sheet Date* to *Events after the Reporting Period* as a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007.

- BC89 Some respondents to ED 1 suggested that it would be onerous to prepare comparative information in accordance with IAS 32 and IAS 39* about financial instruments. They suggested that an entity should be able to apply IAS 39 prospectively from the beginning of the year of its first IFRS financial statements (eg 1 January 2005 for many first-time adopters). They noted that US companies were not required to restate comparatives on the introduction of SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. However, given the Board's emphasis on comparability within the first IFRS financial statements (paragraph BC10) and the assumption of timely planning (paragraph BC27), the Board introduced no general exemption in this area.
- BC89A Nevertheless, the Board noted that the revised IAS 32 and IAS 39* were not issued until December 2003. Additionally, the Board's decision to re-expose its proposals for portfolio hedges of interest rate risk had the effect that some of the requirements will not be finalised until early 2004. The Board was sympathetic to concerns that entities that will be required to comply with IFRSs for the first time in 2005 could not make a timely transition to IFRSs because IAS 39 will not be issued in final form until after the start of 2004. Therefore, the Board decided to exempt entities adopting IFRSs for the first time before 1 January 2006 from producing comparative information that complies with IAS 32 and IAS 39, as revised in 2003, in their first IFRS financial statements.
- BC89B In the light of respondents' comments on the June 2011 exposure draft *Improvements to IFRSs*, the Board amended paragraph 21 as part of *Annual Improvements 2009–2011 Cycle* (issued in May 2012) because it considered that the requirements for comparative information for a first-time adopter should be different from the requirements for comparative information for an existing preparer. The Board noted that a first-time adopter should not be exempted from presenting three statements of financial position and related notes because it might not have presented this information previously on a basis consistent with IFRSs.
- BC89C In addition, the Board considered that a first-time adopter may provide additional comparative information that is presented in accordance with previous GAAP to help the user understand the effects of the transition to IFRSs in accordance with paragraph 22 of IFRS 1. For example, a law or a regulator requires an entity to present the first comparative financial statements in accordance with both IFRSs and previous GAAP and the second comparative in accordance with previous GAAP only. The presentation of this information is an exception from the requirement in paragraph 38C of IAS 1 (to allow an entity to present comparative information in addition to the minimum comparative information required by IFRSs).

Historical summaries

- BC90 Some entities choose, or are required, to present in their financial statements historical summaries of selected data covering periods before the first period for which they present full comparative information. Some argued that an entity should present this information in accordance with IFRSs, to ensure comparability over time. However, the Board concluded that such a requirement would cause costs out of proportion to the benefit to users. The IFRS requires disclosure of the nature of the main adjustments needed to make historical summaries included in financial statements or interim financial reports comply with IFRSs (paragraph 22 of the IFRS). Historical summaries published outside financial statements or interim financial reports are beyond the scope of the IFRS.

Explanation of transition to IFRSs

- BC91 The IFRS requires disclosures about the effect of the transition from previous GAAP to IFRSs. The Board concluded that such disclosures are essential, in the first (annual) IFRS financial statements as well as in interim financial reports (if any), because they help users understand the effect and implications of the transition to IFRSs and how they need to change their

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

analytical models to make the best use of information presented using IFRSs. The required disclosures relate to both:

- (a) the most recent information published in accordance with previous GAAP, so that users have the most up-to-date information; and
- (b) the date of transition to IFRSs. This is an important focus of attention for users, preparers and auditors because the opening IFRS balance sheet is the starting point for accounting in accordance with IFRSs.

BC92 Paragraph 24(a) and (b) of the IFRS requires reconciliations of equity and total comprehensive income. The Board concluded that users would also find it helpful to have information about the other adjustments that affect the opening IFRS balance sheet but do not appear in these reconciliations. Because a reconciliation could be voluminous, the IFRS requires disclosure of narrative information about these adjustments, as well as about adjustments to the cash flow statement (paragraph 25 of the IFRS).

BC92A The Board decided to require a first-time adopter to include in its first IFRS financial statements a reconciliation of total comprehensive income (or, if an entity did not report such a total, profit or loss) in accordance with previous GAAP to total comprehensive income in accordance with IFRSs for the latest period reported in accordance with previous GAAP.

BC92B The Board observed that the amendments to IAS 1 in 2007 regarding the presentation of income and expense might result in users having to change their analytical models to include both income and expense that are recognised in profit or loss and those recognised outside profit or loss. Accordingly, the Board concluded that it would be helpful to those users to provide information on the effect and implication of the transition to IFRSs on all items of income and expense, not only those recognised in profit or loss.

BC92C The Board acknowledged that GAAP in other jurisdictions might not have a notion of total comprehensive income. Accordingly, it decided that an entity should reconcile to total comprehensive income in accordance with IFRSs from the previous GAAP equivalent of total comprehensive income. The previous GAAP equivalent might be profit or loss.

BC93 Paragraph 26 of the IFRS states that the reconciliations should distinguish changes in accounting policies from the correction of errors. Some respondents to ED 1 argued that complying with this requirement could be difficult or costly. However, the Board concluded that both components are important and their disclosure should be required because:

- (a) information about changes in accounting policies helps explain the transition to IFRSs.
- (b) information about errors helps users assess the reliability of financial information. Furthermore, a failure to disclose the effect of material errors would obscure the 'results of the stewardship of management, or the accountability of management for the resources entrusted to it' (*Framework*, paragraph 14^{*}).

BC94 For impairment losses (and reversals) recognised in preparing the opening IFRS balance sheet, paragraph 24(c) of the IFRS requires the disclosures that IAS 36 would require if those impairment losses (and reversals) were recognised during the period beginning with the date of transition to IFRSs. The rationale for this requirement is that there is inevitably subjectivity about impairment losses. This disclosure provides transparency about impairment losses recognised on transition to IFRSs. These losses might otherwise receive less attention than impairment losses recognised in earlier or later periods.

* superseded by Chapter 1 of the *Conceptual Framework*.

- BC95 Paragraph 30 of the IFRS requires disclosures about the use of fair value as deemed cost. Although the adjustment arising from the use of this exemption appears in the reconciliations discussed above, this more specific disclosure highlights it. Furthermore, this exemption differs from the other exemptions that might apply for property, plant and equipment (previous GAAP revaluation or event-driven fair value measurement). The latter two exemptions do not lead to a restatement on transition to IFRSs because they apply only if the measurement was already used in previous GAAP financial statements.

Interim financial reports

- BC96 IAS 34 *Interim Financial Reporting* states that the interim financial report is ‘intended to provide an update on the latest complete set of annual financial statements’ (paragraph 6). Thus, IAS 34 requires less disclosure in interim financial statements than IFRSs require in annual financial statements. However, an entity’s interim financial report in accordance with IAS 34 is less helpful to users if the entity’s latest annual financial statements were prepared using previous GAAP than if they were prepared in accordance with IFRSs. Therefore, the Board concluded that a first-time adopter’s first interim financial report in accordance with IAS 34 should include sufficient information to enable users to understand how the transition to IFRSs affected previously reported annual, as well as interim, figures (paragraphs 32 and 33 of the IFRS).

Accounting policy changes in the year of adoption

- BC97 In *Improvements to IFRSs* issued in May 2010, the Board clarified unclear wording concerning how changes in accounting policies should be addressed by a first-time adopter when those changes occur after the publication of the entity’s first interim financial report. The Board decided that a first-time adopter is exempt from all the requirements of IAS 8 for the interim financial report it presents in accordance with IAS 34 for part of the period covered by its first IFRS financial statements and for its first IFRS financial statements. The Board concluded that to comply with IFRS 1’s requirement to explain its transition to IFRSs, an entity should be required to explain any changes in its accounting policies or the IFRS 1 exemptions it applied between its first IFRS interim financial report and its first IFRS financial statements. The Board decided that the most useful information it could require was updated reconciliations between previous GAAP and IFRSs.

Short-term exemptions from IFRSs

Disclosures about financial instruments

- BC98 ~~[Deleted]* Paragraph E4A of IFRS 1 was added as a consequence of *Annual Improvements to IFRSs 2012–2014 Cycle* issued in September 2014. To avoid the potential use of hindsight when this amendment first took effect, the Board decided that first time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with IFRSs that are included in *Annual Improvements to IFRSs 2012–2014 Cycle*.~~

Deletion of short-term exemptions (amendments issued in December 2016)

- BC99 In *Annual Improvements to IFRS Standards 2014–2016 Cycle*, the Board deleted the short-term exemptions in paragraphs E3–E7 and the related effective date paragraphs. The Board noted that the reliefs provided in those paragraphs were no longer applicable. The reliefs provided had been available to entities only for reporting periods that had passed.

* *Annual Improvements to IFRS Standards 2014–2016 Cycle*, issued in December 2016, deleted some short-term exemptions for first-time adopters (see paragraph BC99), and as a consequence deleted paragraph BC98.

HKFRS 1 IG (Revised)
Revised September 2018~~July 2014~~

Effective for annual periods
beginning on or after 1 July 2009

*Guidance on Implementing
Hong Kong Financial Reporting Standards 1(Revised)*

First-time Adoption of Hong Kong Financial Reporting Standards



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Guidance on implementing IFRS 1 *First-time Adoption of International Financial Reporting Standards*

This guidance accompanies, but is not part of, IFRS 1.

Introduction

IG1 This implementation guidance:

- (a) explains how the requirements of the IFRS interact with the requirements of some other IFRSs (paragraphs IG2–IG62, IG64 and IG65). This explanation addresses those IFRSs that are most likely to involve questions that are specific to first-time adopters.
- (b) includes an illustrative example to show how a first-time adopter might disclose how the transition to IFRSs affected its reported financial position, financial performance and cash flows, as required by paragraphs 24(a) and (b), 25 and 26 of the IFRS (paragraph IG63).

IAS 10 *Events after the Reporting Period*

IG2 Except as described in paragraph IG3, an entity applies IAS 10 in determining whether:

- (a) its opening IFRS statement of financial position reflects an event that occurred after the date of transition to IFRSs; and
- (b) comparative amounts in its first IFRS financial statements reflect an event that occurred after the end of that comparative period.

IG3 Paragraphs 14–17 of the IFRS require some modifications to the principles in IAS 10 when a first-time adopter determines whether changes in estimates are adjusting or non-adjusting events at the date of transition to IFRSs (or, when applicable, the end of the comparative period). Cases 1 and 2 below illustrate those modifications. In case 3 below, paragraphs 14–17 of the IFRS do not require modifications to the principles in IAS 10.

- (a) Case 1—Previous GAAP required estimates of similar items for the date of transition to IFRSs, using an accounting policy that is consistent with IFRSs. In this case, the estimates in accordance with IFRSs need to be consistent with estimates made for that date in accordance with previous GAAP, unless there is objective evidence that those estimates were in error (see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). The entity reports later revisions to those estimates as events of the period in which it makes the revisions, rather than as adjusting events resulting from the receipt of further evidence about conditions that existed at the date of transition to IFRSs.
- (b) Case 2—Previous GAAP required estimates of similar items for the date of transition to IFRSs, but the entity made those estimates using accounting policies that are not consistent with its accounting policies in accordance with IFRSs. In this case, the estimates in accordance with IFRSs need to be consistent with the estimates required in accordance with previous GAAP for that date (unless there is objective evidence that those estimates were in error), after adjusting for the difference in accounting policies. The opening IFRS statement of financial position reflects those adjustments for the difference in accounting policies. As in case 1, the entity reports later revisions to those estimates as events of the period in which it makes the revisions.

For example, previous GAAP may have required an entity to recognise and measure provisions on a basis consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, except that the previous GAAP measurement was on an undiscounted basis. In this example, the entity uses the estimates in accordance with previous GAAP as inputs in making the discounted measurement required by IAS 37.

- (c) Case 3—Previous GAAP did not require estimates of similar items for the date of transition to IFRSs. Estimates in accordance with IFRSs for that date reflect conditions existing at that date. In particular, estimates of market prices, interest rates or foreign exchange rates at the date of transition to IFRSs reflect market conditions at that date. This is consistent with the distinction in IAS 10 between adjusting events after the reporting period and non-adjusting events after the reporting period.

IG Example 1 Estimates

Background

Entity A's first IFRS financial statements are for a period that ends on 31 December 20X5 and include comparative information for one year. In its previous GAAP financial statements for 31 December 20X3 and 20X4, entity A:

- (a) made estimates of accrued expenses and provisions at those dates;
- (b) accounted on a cash basis for a defined benefit pension plan; and
- (c) did not recognise a provision for a court case arising from events that occurred in September 20X4. When the court case was concluded on 30 June 20X5, entity A was required to pay CU1,000* and paid this on 10 July 20X5.

In preparing its first IFRS financial statements, entity A concludes that its estimates in accordance with previous GAAP of accrued expenses and provisions at 31 December 20X3 and 20X4 were made on a basis consistent with its accounting policies in accordance with IFRSs. Although some of the accruals and provisions turned out to be overestimates and others to be underestimates, entity A concludes that its estimates were reasonable and that, therefore, no error had occurred. As a result, accounting for those overestimates and underestimates involves the routine adjustment of estimates in accordance with IAS 8.

Application of requirements

In preparing its opening IFRS statement of financial position at 1 January 20X4 and in its comparative statement of financial position at 31 December 20X4, entity A:

- (a) does not adjust the previous estimates for accrued expenses and provisions; and
- (b) makes estimates (in the form of actuarial assumptions) necessary to account for the pension plan in accordance with IAS 19 *Employee Benefits*. Entity A's actuarial assumptions at 1 January 20X4 and 31 December 20X4 do not reflect conditions that arose after those dates. For example, entity A's:

continued...

* In this guidance monetary amounts are denominated in 'currency units (CU)'.

... continued

IG Example 1 Estimates

- (i) discount rates at 1 January 20X4 and 31 December 20X4 for the pension plan and for provisions reflect market conditions at those dates; and
- (ii) actuarial assumptions at 1 January 20X4 and 31 December 20X4 about future employee turnover rates do not reflect conditions that arose after those dates—such as a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan in 20X5.

The treatment of the court case at 31 December 20X4 depends on the reason why entity A did not recognise a provision in accordance with previous GAAP at that date.

Assumption 1 – Previous GAAP was consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Entity A concluded that the recognition criteria were not met. In this case, entity A's assumptions in accordance with IFRSs are consistent with its assumptions in accordance with previous GAAP. Therefore, entity A does not recognise a provision at 31 December 20X4.

Assumption 2 – Previous GAAP was not consistent with IAS 37. Therefore, entity A develops estimates in accordance with IAS 37. Under IAS 37, an entity determines whether an obligation exists at the end of the reporting period by taking account of all available evidence, including any additional evidence provided by events after the reporting period. Similarly, in accordance with IAS 10 *Events after the Reporting Period*, the resolution of a court case after the reporting period is an adjusting event after the reporting period if it confirms that the entity had a present obligation at that date. In this instance, the resolution of the court case confirms that entity A had a liability in September 20X4 (when the events occurred that gave rise to the court case). Therefore, entity A recognises a provision at 31 December 20X4. Entity A measures that provision by discounting the CU1,000 paid on 10 July 20X5 to its present value, using a discount rate that complies with IAS 37 and reflects market conditions at 31 December 20X4.

IG4 Paragraphs 14–17 of the IFRS do not override requirements in other IFRSs that base classifications or measurements on circumstances existing at a particular date. Examples include:

- (a) the distinction between finance leases and operating leases (see IAS 17 *Leases*);
- (b) the restrictions in IAS 38 *Intangible Assets* that prohibit capitalisation of expenditure on an internally generated intangible asset if the asset did not qualify for recognition when the expenditure was incurred; and
- (c) the distinction between financial liabilities and equity instruments (see IAS 32 *Financial Instruments: Presentation*).

IAS 12 *Income Taxes*

IG5 An entity applies IAS 12 to temporary differences between the carrying amount of the assets and liabilities in its opening IFRS statement of financial position and their tax bases.

IG6 In accordance with IAS 12, the measurement of current and deferred tax reflects tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period. An entity accounts for the effect of changes in tax rates and tax laws when those changes are enacted or substantively enacted.

IAS 16 Property, Plant and Equipment

- IG7 If an entity's depreciation methods and rates in accordance with previous GAAP are acceptable in accordance with IFRSs, it accounts for any change in estimated useful life or depreciation pattern prospectively from when it makes that change in estimate (paragraphs 14 and 15 of the IFRS and paragraph 61 of IAS 16). However, in some cases, an entity's depreciation methods and rates in accordance with previous GAAP may differ from those that would be acceptable in accordance with IFRSs (for example, if they were adopted solely for tax purposes and do not reflect a reasonable estimate of the asset's useful life). If those differences have a material effect on the financial statements, the entity adjusts accumulated depreciation in its opening IFRS statement of financial position retrospectively so that it complies with IFRSs.
- IG8 An entity may elect to use one of the following amounts as the deemed cost of an item of property, plant and equipment:
- (a) fair value at the date of transition to IFRSs (paragraph D5 of the IFRS), in which case the entity gives the disclosures required by paragraph 30 of the IFRS;
 - (b) a revaluation in accordance with previous GAAP that meets the criteria in paragraph D6 of the IFRS;
 - (c) fair value at the date of an event such as a privatisation or initial public offering (paragraph D8 of the IFRS);
 - (d) an allocation of an amount determined under previous GAAP that meets the criteria in paragraph D8A of the IFRS; or
 - (e) the carrying amount under previous GAAP of an item of property, plant and equipment that is used, or was previously used, in operations subject to rate regulation (paragraph D8B of the IFRS).
- IG9 Subsequent depreciation is based on that deemed cost and starts from the date for which the entity established the deemed cost.
- IG10 If an entity chooses as its accounting policy the revaluation model in IAS 16 for some or all classes of property, plant and equipment, it presents the cumulative revaluation surplus as a separate component of equity. The revaluation surplus at the date of transition to IFRSs is based on a comparison of the carrying amount of the asset at that date with its cost or deemed cost. If the deemed cost is the fair value at the date of transition to IFRSs, the entity gives the disclosures required by paragraph 30 of the IFRS.
- IG11 If revaluations in accordance with previous GAAP did not satisfy the criteria in paragraph D6 or D8 of the IFRS, an entity measures the revalued assets in its opening statement of financial position on one of the following bases:
- (a) cost (or deemed cost) less any accumulated depreciation and any accumulated impairment losses under the cost model in IAS 16;
 - (b) deemed cost, being the fair value at the date of transition to IFRSs (paragraph D5 of the IFRS); or
 - (c) revalued amount, if the entity adopts the revaluation model in IAS 16 as its accounting policy in accordance with IFRSs for all items of property, plant and equipment in the same class.

- IG12 IAS 16 requires each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item to be depreciated separately. However, IAS 16 does not prescribe the unit of measure for recognition of an asset, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances (see IAS 16 paragraphs 9 and 43).
- IG13 In some cases, the construction or commissioning of an asset results in an obligation for an entity to dismantle or remove the asset and restore the site on which the asset stands. An entity applies IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in recognising and measuring any resulting provision. The entity applies IAS 16 in determining the resulting amount included in the cost of the asset, before depreciation and impairment losses. Items such as depreciation and, when applicable, impairment losses cause differences between the carrying amount of the liability and the amount included in the carrying amount of the asset. An entity accounts for changes in such liabilities in accordance with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. However, paragraph D21 of IFRS 1 provides an exemption for changes that occurred before the date of transition to IFRSs, and prescribes an alternative treatment where the exemption is used. An example of the first-time adoption of IFRIC 1, which illustrates the use of this exemption, is given at paragraphs IG201–IG203.

IAS 17 Leases

- IG14 At the date of transition to IFRSs, a lessee or lessor classifies leases as operating leases or finance leases on the basis of circumstances existing at the inception of the lease (IAS 17, paragraph 13). In some cases, the lessee and the lessor may agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification in accordance with IAS 17 had the changed terms been in effect at the inception of the lease. If so, the revised agreement is considered as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee) do not give rise to a new classification of a lease.
- IG15 When IAS 17 was revised in 1997, the net cash investment method for recognising finance income of lessors was eliminated. IAS 17 permits finance lessors to eliminate this method prospectively. However, the transitional provisions in IAS 17 do not apply to an entity's opening IFRS statement of financial position (paragraph 9 of the IFRS). Therefore, a finance lessor measures finance lease receivables in its opening IFRS statement of financial position as if the net cash investment method had never been permitted.
- IG16 SIC-15 *Operating Leases—Incentives* applies to lease terms beginning on or after 1 January 1999. However, a first-time adopter applies SIC-15 to all leases, whether they started before or after that date.

~~IAS 18 Revenue~~ IFRS 15 Revenue from Contracts with Customers

- IG17 If an entity has received amounts that do not yet qualify for recognition as revenue in accordance with ~~IFRS 15~~ IAS 18 (for example, the proceeds of a sale that does not qualify for revenue recognition), the entity recognises the amounts received as a liability in its opening IFRS statement of financial position and measures that liability at the amount received, adjusted (if appropriate) for a significant financing component in accordance with IFRS 15.

IAS 19 *Employee Benefits*

IG18 [Deleted]

IG19 An entity's actuarial assumptions at the date of transition to IFRSs are consistent with actuarial assumptions made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 14 of the IFRS). The impact of any later revisions to those assumptions is an actuarial gain or loss of the period in which the entity makes the revisions.

IG20 An entity may need to make actuarial assumptions at the date of transition to IFRSs that were not necessary in accordance with its previous GAAP. Such actuarial assumptions do not reflect conditions that arose after the date of transition to IFRSs. In particular, discount rates and the fair value of plan assets at the date of transition to IFRSs reflect market conditions at that date. Similarly, the entity's actuarial assumptions at the date of transition to IFRSs about future employee turnover rates do not reflect a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan that occurred after the date of transition to IFRSs (paragraph 16 of the IFRS).

IG21 In many cases, an entity's first IFRS financial statements will reflect measurements of employee benefit obligations at three dates: the end of the first IFRS reporting period, the date of the comparative statement of financial position and the date of transition to IFRSs. IAS 19 encourages an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations. To minimise costs, an entity may request a qualified actuary to carry out a detailed actuarial valuation at one or two of these dates and roll the valuation(s) forward or back to the other date(s). Any such roll forward or roll back reflects any material transactions and other material events (including changes in market prices and interest rates) between those dates (IAS 19 paragraph 57).

IAS 21 *The Effects of Changes in Foreign Exchange Rates*

IG21A An entity may, in accordance with previous GAAP, have treated goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation as assets and liabilities of the entity rather than as assets and liabilities of the foreign operation. If so, the entity is permitted to apply prospectively the requirements of paragraph 47 of IAS 21 to all acquisitions occurring after the date of transition to IFRSs.

IFRS 3 *Business Combinations*

IG22 The following examples illustrate the effect of Appendix C of the IFRS, assuming that a first-time adopter uses the exemption.

IG Example 2 Business combination**Background**

Entity B's first IFRS financial statements are for a period that ends on 31 December 20X5 and include comparative information for 20X4 only. On 1 July 20X1, entity B acquired 100 per cent of subsidiary C. In accordance with its previous GAAP, entity B:

- (a) classified the business combination as an acquisition by entity B.
- (b) measured the assets acquired and liabilities assumed at the following amounts in accordance with previous GAAP at 31 December 20X3 (date of transition to IFRSs):
 - (i) identifiable assets less liabilities for which IFRSs require cost-based measurement at a date after the business combination: CU200 (with a tax base of CU150 and an applicable tax rate of 30 per cent).
 - (ii) pension liability (for which the present value of the defined benefit obligation measured in accordance with IAS 19 *Employee Benefits* is CU130 and the fair value of plan assets is CU100): nil (because entity B used a pay-as-you-go cash method of accounting for pensions in accordance with its previous GAAP). The tax base of the pension liability is also nil.
 - (iii) goodwill: CU180.
- (c) did not, at the acquisition date, recognise deferred tax arising from temporary differences associated with the identifiable assets acquired and liabilities assumed.

Application of requirements

In its opening (consolidated) IFRS statement of financial position, entity B:

- (a) classifies the business combination as an acquisition by entity B even if the business combination would have qualified in accordance with IFRS 3 as a reverse acquisition by subsidiary C (paragraph C4(a) of the IFRS).
- (b) does not adjust the accumulated amortisation of goodwill. Entity B tests the goodwill for impairment in accordance with IAS 36 *Impairment of Assets* and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRSs. If no impairment exists, the carrying amount of the goodwill remains at CU180 (paragraph C4(g) of the IFRS).
- (c) for those net identifiable assets acquired for which IFRSs require cost-based measurement at a date after the business combination, treats their carrying amount in accordance with previous GAAP immediately after the business combination as their deemed cost at that date (paragraph C4(e) of the IFRS).
- (d) does not restate the accumulated depreciation and amortisation of the net identifiable assets in (c), unless the depreciation methods and rates in accordance with previous GAAP result in amounts that differ materially from those required in accordance with IFRSs (for example, if they were adopted solely for tax purposes and do not reflect a reasonable estimate of the asset's useful life in accordance with IFRSs). If no such restatement is made, the carrying amount of those assets in the opening IFRS statement of financial position equals their carrying amount in accordance with previous GAAP at the date of transition to IFRSs (CU200) (paragraph IG7).

continued...

...continued**IG Example 2 Business combination**

- (e) if there is any indication that identifiable assets are impaired, tests those assets for impairment, based on conditions that existed at the date of transition to IFRSs (see IAS 36).
- (f) recognises the pension liability, and measures it, at the present value of the defined benefit obligation (CU130) less the fair value of the plan assets (CU100), giving a carrying amount of CU30, with a corresponding debit of CU30 to retained earnings (paragraph C4(d) of the IFRS). However, if subsidiary C had already adopted IFRSs in an earlier period, entity B would measure the pension liability at the same amount as in subsidiary C's financial statements (paragraph D17 of the IFRS and IG Example 9).
- (g) recognises a net deferred tax liability of CU6 (CU20 at 30 per cent) arising from:
- (i) the taxable temporary difference of CU50 (CU200 less CU150) associated with the identifiable assets acquired and non-pension liabilities assumed, less
 - (ii) the deductible temporary difference of CU30 (CU30 less nil) associated with the pension liability.

The entity recognises the resulting increase in the deferred tax liability as a deduction from retained earnings (paragraph C4(k) of the IFRS). If a taxable temporary difference arises from the initial recognition of the goodwill, entity B does not recognise the resulting deferred tax liability (paragraph 15(a) of IAS 12 *Income Taxes*).

IG Example 3 Business combination—restructuring provision**Background**

Entity D's first IFRS financial statements are for a period that ends on 31 December 20X5 and include comparative information for 20X4 only. On 1 July 20X3, entity D acquired 100 per cent of subsidiary E. In accordance with its previous GAAP, entity D recognised an (undiscounted) restructuring provision of CU100 that would not have qualified as an identifiable liability in accordance with IFRS 3. The recognition of this restructuring provision increased goodwill by CU100. At 31 December 20X3 (date of transition to IFRSs), entity D:

- (a) had paid restructuring costs of CU60; and
- (b) estimated that it would pay further costs of CU40 in 20X4, and that the effects of discounting were immaterial. At 31 December 20X3, those further costs did not qualify for recognition as a provision in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Application of requirements

In its opening IFRS statement of financial position, entity D:

- (a) does not recognise a restructuring provision (paragraph C4(c) of the IFRS).
- (b) does not adjust the amount assigned to goodwill. However, entity D tests the goodwill for impairment in accordance with IAS 36 *Impairment of Assets*, and recognises any resulting impairment loss (paragraph C4(g) of the IFRS).
- (c) as a result of (a) and (b), reports retained earnings in its opening IFRS statement of financial position that are higher by CU40 (before income taxes, and before recognising any impairment loss) than in the statement of financial position at the same date in accordance with previous GAAP.

IG Example 4 Business combination—intangible assets**Background**

Entity F's first IFRS financial statements are for a period that ends on 31 December 20X5 and include comparative information for 20X4 only. On 1 July 20X1 entity F acquired 75 per cent of subsidiary G. In accordance with its previous GAAP, entity F assigned an initial carrying amount of CU200 to intangible assets that would not have qualified for recognition in accordance with IAS 38 *Intangible Assets*. The tax base of the intangible assets was nil, giving rise to a deferred tax liability (at 30 per cent) of CU60.

On 31 December 20X3 (the date of transition to IFRSs) the carrying amount of the intangible assets in accordance with previous GAAP was CU160, and the carrying amount of the related deferred tax liability was CU48 (30 per cent of CU160).

Application of requirements

Because the intangible assets do not qualify for recognition as separate assets in accordance with IAS 38, entity F transfers them to goodwill, together with the related deferred tax liability (CU48) and non-controlling interests (paragraph C4(g)(i) of the IFRS). The related non-controlling interests amount to CU28 (25 per cent of [CU160 – CU48 = CU112]). Thus, the increase in goodwill is CU84—intangible assets (CU160) less deferred tax liability (CU48) less non-controlling interests (CU28).

Entity F tests the goodwill for impairment in accordance with IAS 36 *Impairment of Assets* and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRSs (paragraph C4(g)(ii) of the IFRS).

IG Example 5 Business combination—goodwill deducted from equity and treatment of related intangible assets
Background

Entity H acquired a subsidiary before the date of transition to IFRSs. In accordance with its previous GAAP, entity H:

- (a) recognised goodwill as an immediate deduction from equity;
- (b) recognised an intangible asset of the subsidiary that does not qualify for recognition as an asset in accordance with IAS 38 *Intangible Assets*; and
- (c) did not recognise an intangible asset of the subsidiary that would qualify in accordance with IAS 38 for recognition as an asset in the financial statements of the subsidiary. The subsidiary held the asset at the date of its acquisition by entity H.

Application of requirements

In its opening IFRS statement of financial position, entity H:

- (a) does not recognise the goodwill, as it did not recognise the goodwill as an asset in accordance with previous GAAP (paragraph C4(g)–(i) of the IFRS).
- (b) does not recognise the intangible asset that does not qualify for recognition as an asset in accordance with IAS 38. Because entity H deducted goodwill from equity in accordance with its previous GAAP, the elimination of this intangible asset reduces retained earnings (paragraph C4(c)(ii) of the IFRS).
- (c) recognises the intangible asset that qualifies in accordance with IAS 38 for recognition as an asset in the financial statements of the subsidiary, even though the amount assigned to it in accordance with previous GAAP in entity H's consolidated financial statements was nil (paragraph C4(f) of the IFRS). The recognition criteria in IAS 38 include the availability of a reliable measurement of cost (paragraphs IG45–IG48) and entity H measures the asset at cost less accumulated depreciation and less any impairment losses identified in accordance with IAS 36 *Impairment of Assets*. Because entity H deducted goodwill from equity in accordance with its previous GAAP, the recognition of this intangible asset increases retained earnings (paragraph C4(c)(ii) of the IFRS). However, if this intangible asset had been subsumed in goodwill recognised as an asset in accordance with previous GAAP, entity H would have decreased the carrying amount of that goodwill accordingly (and, if applicable, adjusted deferred tax and non-controlling interests) (paragraph C4(g)(i) of the IFRS).

IG Example 6 Business combination—subsidiary not consolidated in accordance with previous GAAP**Background**

Parent J's date of transition to IFRSs is 1 January 20X4. In accordance with its previous GAAP, parent J did not consolidate its 75 per cent subsidiary K, acquired in a business combination on 15 July 20X1. On 1 January 20X4:

- (a) the cost of parent J's investment in subsidiary K is CU180.
- (b) in accordance with IFRSs, subsidiary K would measure its assets at CU500 and its liabilities (including deferred tax in accordance with IAS 12 *Income Taxes*) at CU300. On this basis, subsidiary K's net assets are CU200 in accordance with IFRSs.

Application of requirements

Parent J consolidates subsidiary K. The consolidated statement of financial position at 1 January 20X4 includes:

- (a) subsidiary K's assets at CU500 and liabilities at CU300;
- (b) non-controlling interests of CU50 (25 per cent of [CU500 – CU300]); and
- (c) goodwill of CU30 (cost of CU180 less 75 per cent of [CU500 – CU300]) (paragraph C4(j) of the IFRS). Parent J tests the goodwill for impairment in accordance with IAS 36 *Impairment of Assets* and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRSs (paragraph C4(g)(ii) of the IFRS).

IG Example 7 Business combination—finance lease not capitalised in accordance with previous GAAP**Background**

Parent L's date of transition to IFRSs is 1 January 20X4. Parent L acquired subsidiary M on 15 January 20X1 and did not capitalise subsidiary M's finance leases. If subsidiary M prepared financial statements in accordance with IFRSs, it would recognise finance lease obligations of 300 and leased assets of 250 at 1 January 20X4.

Application of requirements

In its consolidated opening IFRS statement of financial position, parent L recognises finance lease obligations of CU300 and leased assets of CU250, and charges CU50 to retained earnings (paragraph C4(f)).

IAS 23 *Borrowing Costs*

IG23 On first adopting IFRSs, an entity begins capitalising borrowing costs (IAS 23 as revised in 2007). In accordance with paragraph D23 of the IFRS, an entity:

- (a) capitalises borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009 or the date of transition to IFRSs (whichever is later);
- (b) may elect to designate any date before 1 January 2009 or the date of transition to IFRSs (whichever is later) and to capitalise borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

However, if the entity established a deemed cost for an asset, the entity does not capitalise borrowing costs incurred before the date of the measurement that established the deemed cost.

IG24 IAS 23 requires disclosure of interest capitalised during the period. Neither IAS 23 nor the IFRS requires disclosure of the cumulative amount capitalised.

IG25 [Deleted]

IFRS 10 *Consolidated Financial Statements*

IG26 A first-time adopter consolidates all subsidiaries (as defined in IFRS 10), unless IFRS 10 requires otherwise.

IG27 If a first-time adopter did not consolidate a subsidiary in accordance with previous GAAP, then:

- (a) in its consolidated financial statements, the first-time adopter measures the subsidiary's assets and liabilities at the same carrying amounts as in the IFRS financial statements of the subsidiary, after adjusting for consolidation procedures and for the effects of the business combination in which it acquired the subsidiary (paragraph D17 of the IFRS). If the subsidiary has not adopted IFRSs in its financial statements, the carrying amounts described in the previous sentence are those that IFRSs would require in those financial statements (paragraph C4(j) of the IFRS).
- (b) if the parent acquired the subsidiary in a business combination before the date of transition to IFRS, the parent recognises goodwill, as explained in IG Example 6.
- (c) if the parent did not acquire the subsidiary in a business combination because it created the subsidiary, the parent does not recognise goodwill.

IG28 When a first-time adopter adjusts the carrying amounts of assets and liabilities of its subsidiaries in preparing its opening IFRS statement of financial position, this may affect non-controlling interests and deferred tax.

IG29 IG Examples 8 and 9 illustrate paragraphs D16 and D17 of the IFRS, which address cases where a parent and its subsidiary become first-time adopters at different dates.

IG Example 8 Parent adopts IFRSs before subsidiary**Background**

Parent N presents its (consolidated) first IFRS financial statements in 20X5. Its foreign subsidiary O, wholly owned by parent N since formation, prepares information in accordance with IFRSs for internal consolidation purposes from that date, but subsidiary O does not present its first IFRS financial statements until 20X7.

Application of requirements

If subsidiary O applies paragraph D16(a) of the IFRS, the carrying amounts of its assets and liabilities are the same in both its opening IFRS statement of financial position at 1 January 20X6 and parent N's consolidated statement of financial position (except for adjustments for consolidation procedures) and are based on parent N's date of transition to IFRSs.

Alternatively, subsidiary O may, in accordance with paragraph D16(b) of the IFRS, measure all its assets or liabilities based on its own date of transition to IFRSs (1 January 20X6). However, the fact that subsidiary O becomes a first-time adopter in 20X7 does not change the carrying amounts of its assets and liabilities in parent N's consolidated financial statements.

IG Example 9 Subsidiary adopts IFRSs before parent**Background**

Parent P presents its (consolidated) first IFRS financial statements in 20X7. Its foreign subsidiary Q, wholly owned by parent P since formation, presented its first IFRS financial statements in 20X5. Until 20X7, subsidiary Q prepared information for internal consolidation purposes in accordance with parent P's previous GAAP.

Application of requirements

The carrying amounts of subsidiary Q's assets and liabilities at 1 January 20X6 are the same in both parent P's (consolidated) opening IFRS statement of financial position and subsidiary Q's financial statements (except for adjustments for consolidation procedures) and are based on subsidiary Q's date of transition to IFRSs. The fact that parent P becomes a first-time adopter in 20X7 does not change those carrying amounts (paragraph D17 of the IFRS).

IG30 Paragraphs D16 and D17 of the IFRS do not override the following requirements:

- (a) to apply Appendix C of the IFRS to assets acquired, and liabilities assumed, in a business combination that occurred before the acquirer's date of transition to IFRSs. However, the acquirer applies paragraph D17 to new assets acquired, and liabilities assumed, by the acquiree after that business combination and still held at the acquirer's date of transition to IFRSs.
- (b) to apply the rest of the IFRS in measuring all assets and liabilities for which paragraphs D16 and D17 are not relevant.
- (c) to give all disclosures required by the IFRS as of the first-time adopter's own date of transition to IFRSs.

- IG31 Paragraph D16 of the IFRS applies if a subsidiary becomes a first-time adopter later than its parent, for example if the subsidiary previously prepared a reporting package in accordance with IFRSs for consolidation purposes but did not present a full set of financial statements in accordance with IFRSs. This may be relevant not only when a subsidiary's reporting package complies fully with the recognition and measurement requirements of IFRSs, but also when it is adjusted centrally for matters such as review of events after the reporting period and central allocation of pension costs. For the disclosure required by paragraph 26 of the IFRS, adjustments made centrally to an unpublished reporting package are not corrections of errors. However, paragraph D16 does not permit a subsidiary to ignore misstatements that are immaterial to the consolidated financial statements of its parent but material to its own financial statements.

IAS 29 *Financial Reporting in Hyperinflationary Economies*

- IG32 An entity complies with IAS 21 *The Effects of Changes in Foreign Exchange Rates* in determining its functional currency and presentation currency. When the entity prepares its opening IFRS statement of financial position, it applies IAS 29 to any periods during which the economy of the functional currency or presentation currency was hyperinflationary.
- IG33 An entity may elect to use the fair value of an item of property, plant and equipment at the date of transition to IFRSs as its deemed cost at that date (paragraph D5 of the IFRS), in which case it gives the disclosures required by paragraph 30 of the IFRS.
- IG34 If an entity elects to use the exemptions in paragraphs D5-D8 of the IFRS, it applies IAS 29 to periods after the date for which the revalued amount or fair value was determined.

IAS 32 *Financial Instruments: Presentation*

- IG35 In its opening IFRS statement of financial position, an entity applies the criteria in IAS 32 to classify financial instruments issued (or components of compound instruments issued) as either financial liabilities or equity instruments in accordance with the substance of the contractual arrangement when the instrument first satisfied the recognition criteria in IAS 32 (paragraphs 15 and 30), without considering events after that date (other than changes to the terms of the instruments).
- IG36 For compound instruments outstanding at the date of transition to IFRSs, an entity determines the initial carrying amounts of the components on the basis of circumstances existing when the instrument was issued (IAS 32 paragraph 30). An entity determines those carrying amounts using the version of IAS 32 effective at the end of its first IFRS reporting period. If the liability component is no longer outstanding at the date of transition to IFRSs, a first-time adopter need not separate the initial equity component of the instrument from the cumulative interest accreted on the liability component (paragraph D18 of the IFRS).

IAS 34 *Interim Financial Reporting*

- IG37 IAS 34 applies if an entity is required, or elects, to present an interim financial report in accordance with IFRSs. Accordingly, neither IAS 34 nor the IFRS requires an entity:
- (a) to present interim financial reports that comply with IAS 34; or
 - (b) to prepare new versions of interim financial reports presented in accordance with previous GAAP. However, if an entity does prepare an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements, the entity restates the comparative information presented in that report so that it complies with IFRSs.

- IG38 An entity applies the IFRS in each interim financial report that it presents in accordance with IAS 34 for part of the period covered by its first IFRS financial statements. In particular, paragraph 32 of the IFRS requires an entity to disclose various reconciliations (see IG Example 10).

IG Example 10 Interim financial reporting
Background Entity R's first IFRS financial statements are for a period that ends on 31 December 20X5, and its first interim financial report in accordance with IAS 34 is for the quarter ended 31 March 20X5. Entity R prepared previous GAAP annual financial statements for the year ended 31 December 20X4, and prepared quarterly reports throughout 20X4. Application of requirements In each quarterly interim financial report for 20X5, entity R includes reconciliations of: (a) its equity in accordance with previous GAAP at the end of the comparable quarter of 20X4 to its equity in accordance with IFRSs at that date; and (b) its total comprehensive income (or, if it did not report such a total, profit or loss) in accordance with previous GAAP for the comparable quarter of 20X4 (current and year to date) to its total comprehensive income in accordance with IFRSs. In addition to the reconciliations required by (a) and (b) and the disclosures required by IAS 34, entity R's interim financial report for the first quarter of 20X5 includes reconciliations of (or a cross-reference to another published document that includes these reconciliations): (a) its equity in accordance with previous GAAP at 1 January 20X4 and 31 December 20X4 to its equity in accordance with IFRSs at those dates; and (b) its total comprehensive income (or, if it did not report such a total, profit or loss) for 20X4 in accordance with previous GAAP to its total comprehensive income for 20X4 in accordance with IFRSs. Each of the above reconciliations gives sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. Entity R also explains the material adjustments to the statement of cash flows. If entity R becomes aware of errors made in accordance with previous GAAP, the reconciliations distinguish the correction of those errors from changes in accounting policies. If entity R did not, in its most recent annual financial statements in accordance with previous GAAP, disclose information material to an understanding of the current interim period, its interim financial reports for 20X5 disclose that information or include a cross-reference to another published document that includes it (paragraph 33 of the IFRS).

IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

- IG39 An entity applies IAS 36 in:
- (a) determining whether any impairment loss exists at the date of transition to IFRSs; and
 - (b) measuring any impairment loss that exists at that date, and reversing any impairment loss that no longer exists at that date. An entity's first IFRS financial statements include the disclosures that IAS 36 would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRSs (paragraph 24(c) of the IFRS).
- IG40 The estimates used to determine whether an entity recognises an impairment loss or provision (and to measure any such impairment loss or provision) at the date of transition to IFRSs are consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error (paragraphs 14 and 15 of the IFRS). The entity reports the impact of any later revisions to those estimates as an event of the period in which it makes the revisions.
- IG41 In assessing whether it needs to recognise an impairment loss or provision (and in measuring any such impairment loss or provision) at the date of transition to IFRSs, an entity may need to make estimates for that date that were not necessary in accordance with its previous GAAP. Such estimates and assumptions do not reflect conditions that arose after the date of transition to IFRSs (paragraph 16 of the IFRS).
- IG42 The transitional provisions in IAS 36 and IAS 37 do not apply to an entity's opening IFRS statement of financial position (paragraph 9 of the IFRS).
- IG43 IAS 36 requires the reversal of impairment losses in some cases. If an entity's opening IFRS statement of financial position reflects impairment losses, the entity recognises any later reversal of those impairment losses in profit or loss (except when IAS 36 requires the entity to treat that reversal as a revaluation). This applies to both impairment losses recognised in accordance with previous GAAP and additional impairment losses recognised on transition to IFRSs.

IAS 38 *Intangible Assets*

- IG44 An entity's opening IFRS statement of financial position:
- (a) excludes all intangible assets and other intangible items that do not meet the criteria for recognition in accordance with IAS 38 at the date of transition to IFRSs; and
 - (b) includes all intangible assets that meet the recognition criteria in IAS 38 at that date, except for intangible assets acquired in a business combination that were not recognised in the acquirer's consolidated statement of financial position in accordance with previous GAAP and also would not qualify for recognition in accordance with IAS 38 in the separate statement of financial position of the acquiree (see paragraph C4(f) of the IFRS).

IG45 The criteria in IAS 38 require an entity to recognise an intangible asset if, and only if:

- (a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- (b) the cost of the asset can be measured reliably.

IAS 38 supplements these two criteria with further, more specific, criteria for internally generated intangible assets.

IG46 In accordance with paragraphs 65 and 71 of IAS 38, an entity capitalises the costs of creating internally generated intangible assets prospectively from the date when the recognition criteria are met. IAS 38 does not permit an entity to use hindsight to conclude retrospectively that these recognition criteria are met. Therefore, even if an entity concludes retrospectively that a future inflow of economic benefits from an internally generated intangible asset is probable and the entity is able to reconstruct the costs reliably, IAS 38 prohibits it from capitalising the costs incurred before the date when the entity both:

- (a) concludes, based on an assessment made and documented at the date of that conclusion, that it is probable that future economic benefits from the asset will flow to the entity; and
- (b) has a reliable system for accumulating the costs of internally generated intangible assets when, or shortly after, they are incurred.

IG47 If an internally generated intangible asset qualifies for recognition at the date of transition to IFRSs, an entity recognises the asset in its opening IFRS statement of financial position even if it had recognised the related expenditure as an expense in accordance with previous GAAP. If the asset does not qualify for recognition in accordance with IAS 38 until a later date, its cost is the sum of the expenditure incurred from that later date.

IG48 The criteria discussed in paragraph IG45 also apply to an intangible asset acquired separately. In many cases, contemporaneous documentation prepared to support the decision to acquire the asset will contain an assessment of the future economic benefits. Furthermore, as explained in paragraph 26 of IAS 38, the cost of a separately acquired intangible asset can usually be measured reliably.

IG49 For an intangible asset acquired in a business combination before the date of transition to IFRSs, its carrying amount in accordance with previous GAAP immediately after the business combination is its deemed cost in accordance with IFRSs at that date (paragraph C4(e) of the IFRS). If that carrying amount was zero, the acquirer does not recognise the intangible asset in its consolidated opening IFRS statement of financial position, unless it would qualify in accordance with IAS 38, applying the criteria discussed in paragraphs IG45-IG48, for recognition at the date of transition to IFRSs in the statement of financial position of the acquiree (paragraph C4(f) of the IFRS). If those recognition criteria are met, the acquirer measures the asset on the basis that IAS 38 would require in the statement of financial position of the acquiree. The resulting adjustment affects goodwill (paragraph C4(g)(i) of the IFRS).

IG50 A first-time adopter may elect to use the fair value of an intangible asset at the date of an event such as a privatisation or initial public offering as its deemed cost at the date of that event (paragraph D8 of the IFRS), provided that the intangible asset qualifies for recognition in accordance with IAS 38 (paragraph 10 of the IFRS). In addition, if, and only if, an intangible asset meets both the recognition criteria in IAS 38 (including reliable measurement of original cost) and the criteria in IAS 38 for revaluation (including the existence of an active market), a first-time adopter may elect to use one of the following amounts as its deemed cost (paragraph D7 of the IFRS):

- (a) fair value at the date of transition to IFRSs (paragraph D5 of the IFRS), in which case the entity gives the disclosures required by paragraph 30 of the IFRS; or
- (b) a revaluation in accordance with previous GAAP that meets the criteria in paragraph D6 of the IFRS.

IG51 If an entity's amortisation methods and rates in accordance with previous GAAP would be acceptable in accordance with IFRSs, the entity does not restate the accumulated amortisation in its opening IFRS statement of financial position. Instead, the entity accounts for any change in estimated useful life or amortisation pattern prospectively from the period when it makes that change in estimate (paragraph 14 of the IFRS and paragraph 104 of IAS 38). However, in some cases, an entity's amortisation methods and rates in accordance with previous GAAP may differ from those that would be acceptable in accordance with IFRSs (for example, if they were adopted solely for tax purposes and do not reflect a reasonable estimate of the asset's useful life). If those differences have a material effect on the financial statements, the entity adjusts the accumulated amortisation in its opening IFRS statement of financial position retrospectively so that it complies with IFRSs (paragraph 14 of the IFRS). However, if an entity uses the exemption in paragraph D8B, it uses the carrying amount of the intangible asset at the date of transition to IFRSs as deemed cost as if it had acquired an intangible asset with the same remaining service potential for that amount at the date of transition to IFRSs. Subsequent amortisation is based on that deemed cost and starts from the date of transition to IFRSs.

IFRS 9 Financial Instruments~~IAS 39 Financial Instruments: Recognition and Measurement~~

IG52 An entity recognises and measures all financial assets and financial liabilities in its opening IFRS statement of financial position in accordance with IFRS 9~~IAS 39~~, except as specified in paragraphs B2-B6 of the IFRS, which address derecognition and hedge accounting.

Recognition

IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with IFRS 9~~IAS 39~~ and have not yet qualified for derecognition in accordance with IFRS 9~~IAS 39~~, except non-derivative financial assets and non-derivative financial liabilities derecognised in accordance with previous GAAP before 1 January 2004~~the date of transition to IFRSs~~, to which the entity does not choose to apply paragraph B3 (see paragraphs B2 and B3 of the IFRS). For example, an entity that does not apply paragraph B3 does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred before 1 January 2004~~the date of transition to IFRSs~~ if those transactions qualified for derecognition in accordance with previous GAAP. However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after 1 January 2004~~the date of transition to IFRSs~~, those further transfers qualify for derecognition only if they meet the derecognition criteria of IFRS 9~~IAS 39~~.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition in accordance with IFRS 9~~IAS 39~~, or have already qualified for derecognition in accordance with IFRS 9~~IAS 39~~.

Embedded derivatives

IG55 When IFRS 9~~IAS 39~~ requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IFRS 9~~IAS 39~~ reflect circumstances at that date (IFRS 9 paragraph 4.3.3~~IAS 39 paragraph 11~~). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it measures the entire combined contract as at fair value through profit or loss (IFRS 9 paragraph 4.3.6)~~it treats the entire combined contract as a financial instrument held for trading (IAS 39 paragraph 12)~~. This

~~results in fair value measurement (except when the entity cannot determine a reliable fair value, see IAS 39 paragraph 46(c)), with changes in fair value recognised in profit or loss.—~~

Measurement

IG56 In preparing its opening IFRS statement of financial position, an entity applies the criteria in IFRS 9 to classified financial instruments on the basis of the facts and circumstances that exist at the date of transition to IFRSs. The resulting classifications are applied retrospectively.~~IAS 39 to identify those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost. In particular:—~~

- ~~(a) — to comply with IAS 39 paragraph 51, classification of financial assets as held-to-maturity investments relies on a designation made by the entity in applying IAS 39 reflecting the entity's intention and ability at the date of transition to IFRSs. It follows that sales or transfers of held-to-maturity investments before the date of transition to IFRSs do not trigger the 'tainting' rules in IAS 39, paragraph 9.—~~
- ~~(b) — to comply with IAS 39 paragraph 9, the category of 'loans and receivables' refers to the circumstances when the financial asset first satisfied the recognition criteria in IAS 39.—~~
- ~~(c) — in accordance with IAS 39 paragraph 9, derivative financial assets and derivative financial liabilities are always deemed held for trading (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). The result is that an entity measures at fair value all derivative financial assets and derivative financial liabilities that are not financial guarantee contracts.—~~
- ~~(d) — to comply with IAS 39 paragraph 50, an entity classifies a non-derivative financial asset or non-derivative financial liability in its opening IFRS statement of financial position as at fair value through profit or loss only if the asset or liability was:—~~
 - ~~(i) — acquired or incurred principally for the purpose of selling or repurchasing it in the near term;—~~
 - ~~(ii) — at the date of transition to IFRSs, part of a portfolio of identified financial instruments that were managed together and for which there was evidence of a recent actual pattern of short-term profit-taking; or~~
 - ~~(iii) — designated as at fair value through profit or loss at the date of transition to IFRSs, for an entity that presents its first IFRS financial statements for an annual period beginning on or after 1 January 2006.—~~
 - ~~(iv) — designated as at fair value through profit or loss at the start of its first IFRS reporting period, for an entity that presents its first IFRS financial statements for an annual period beginning before 1 January 2006 and applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 of IAS 39. If the entity restates comparative information for IAS 39 it shall restate the comparative information only if the financial assets or financial liabilities designated at the start of its first IFRS reporting period would have met the criteria for such designation in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at the date of transition to IFRSs or, if acquired after the date of transition to IFRSs, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition. For groups of financial assets, financial liabilities or both that are designated in accordance with paragraph 9(b)(ii) of IAS 39 at the start of the first IFRS reporting period, the comparative financial statements should be restated for all the financial assets and financial liabilities within the groups at the date of transition to IFRSs even if individual financial assets or liabilities within a group were derecognised during the comparative period.—~~

- (e) ~~to comply with IAS 39 paragraph 9, available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale and those non-derivative financial assets that are not in any of the previous categories.~~

- IG57 For those financial assets and financial liabilities measured at amortised cost in the opening IFRS statement of financial position, an entity determines the gross carrying amount of the financial assets and the amortised cost of the financial liabilities ~~their cost~~ on the basis of circumstances existing when the assets and liabilities first satisfied the recognition criteria in ~~IAS 39~~ IFRS 9. However, if the entity acquired those financial assets and financial liabilities in a past business combination, their carrying amount in accordance with previous GAAP immediately following the business combination is their deemed cost in accordance with IFRSs at that date (paragraph C4(e) of the IFRS).
- IG58 ~~[Deleted]~~ An entity's estimates of loan impairments at the date of transition to IFRSs are consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 14 of the IFRS). The entity treats the impact of any later revisions to those estimates as impairment losses (or, if the criteria in IAS 39 are met, reversals of impairment losses) of the period in which it makes the revisions.

Transition adjustments

- IG58A An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings (or another component of equity, as appropriate) at the date of transition to IFRSs only to the extent that it results from adopting ~~IAS 39~~ IFRS 9. Because all derivatives, other than those that are financial guarantee contracts, a commitment to provide a loan at a below-market interest rate, a loan commitment that is subject to the impairment requirements of IFRS 9 or are designated and effective hedging instruments, are measured at fair value through profit or loss ~~classified as held for trading~~, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which ~~IAS 39~~ IFRS 9 is initially applied (other than for a derivative that is a financial guarantee contract, a commitment to provide a loan at a below-market interest rate or a designated and effective hedging instrument).
- IG58B IAS 8 (as revised in 2003) applies to adjustments resulting from changes in estimates. If an entity is unable to determine whether a particular portion of the adjustment is a transition adjustment or a change in estimate, it treats that portion as a change in accounting estimate in accordance with IAS 8, with appropriate disclosures (IAS 8 paragraphs 32-40).
- IG59 An entity may, in accordance with its previous GAAP, have measured investments at fair value and recognised the revaluation gain outside profit or loss. If an investment is classified as at fair value through profit or loss, the ~~pre-IFRS 9~~ pre-IFRS 9 revaluation gain that had been recognised outside profit or loss is reclassified into retained earnings on initial application of ~~IAS 39~~ IFRS 9. If, on initial application of ~~IAS 39~~ IFRS 9, an investment is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9 or is designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9, classified as available for sale, then the pre-IFRS 9 ~~pre-IFRS 9~~ revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on these financial assets in accordance with IFRS 9 ~~the available-for-sale financial asset in other comprehensive income and accumulates the cumulative gains and losses in that separate component of equity until the investment is impaired, sold, collected or otherwise disposed of. On subsequent derecognition or impairment of the available for sale financial asset, the entity reclassifies to profit or loss the cumulative gain or loss remaining in equity (IAS 39 paragraph 55(b)).~~

Hedge accounting

- IG60 Paragraphs B4-B6 of the IFRS deal with hedge accounting. The designation and documentation of a hedge relationship must be completed on or before the date of transition to IFRSs if the hedge relationship is to qualify for hedge accounting from that date. Hedge accounting can be applied prospectively only from the date that the hedge relationship is fully designated and documented.
- IG60A An entity may, in accordance with its previous GAAP, have deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, an entity adjusts the carrying amount of the hedged item at the date of transition to IFRSs. The adjustment is the lower of:
- (a) that portion of the cumulative change in the fair value of the hedged item that ~~reflects the designated hedged risk and~~ was not recognised in accordance with previous GAAP; and
 - (b) that portion of the cumulative change in the fair value of the hedging instrument ~~that reflects the designated hedged risk and~~, in accordance with previous GAAP, was either (i) not recognised or (ii) deferred in the statement of financial position as an asset or liability.
- IG60B An entity may, in accordance with its previous GAAP, have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of transition to IFRSs, the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in the cash flow hedge reserve within equity. Any net cumulative gain or loss that has been reclassified to the cash flow hedge reserve equity on initial application of IFRS 9/IAS 39 remains there in equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects profit or loss or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss is reclassified from the cash flow hedge reserve equity to profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge in accordance with IFRS 9/IAS 39, hedge accounting is no longer appropriate starting from the date of transition to IFRSs.

IAS 40 Investment Property

- IG61 An entity that adopts the fair value model in IAS 40 measures its investment property at fair value at the date of transition to IFRSs. The transitional requirements of IAS 40 do not apply (paragraph 9 of the IFRS).
- IG62 An entity that adopts the cost model in IAS 40 applies paragraphs IG7-IG13 on property, plant and equipment.

Explanation of transition to IFRSs

- IG63 Paragraphs 24(a) and (b), 25 and 26 of the IFRS require a first-time adopter to disclose reconciliations that give sufficient detail to enable users to understand the material adjustments to the statement of financial position, statement of comprehensive income and, if applicable, statement of cash flows. Paragraph 24(a) and (b) requires specific reconciliations of equity and total comprehensive income. IG Example 11 shows one way of satisfying these requirements.

IG Example 11 Reconciliation of equity and total comprehensive income**Background**

An entity first adopted IFRSs in 20X5, with a date of transition to IFRSs of 1 January 20X4. Its last financial statements in accordance with previous GAAP were for the year ended 31 December 20X4.

Application of requirements

The entity's first IFRS financial statements include the reconciliations and related notes shown below.

Among other things, this example includes a reconciliation of equity at the date of transition to IFRSs (1 January 20X4). The IFRS also requires a reconciliation at the end of the last period presented in accordance with previous GAAP (not included in this example).

In practice, it may be helpful to include cross-references to accounting policies and supporting analyses that give further explanation of the adjustments shown in the reconciliations below.

If a first-time adopter becomes aware of errors made in accordance with previous GAAP, the reconciliations distinguish the correction of those errors from changes in accounting policies (paragraph 26 of the IFRS). This example does not illustrate disclosure of a correction of an error.

Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)

Note		<i>Previous GAAP</i> <i>CU</i>	<i>Effect of</i> <i>transition to</i> <i>IFRSs</i> <i>CU</i>	<i>IFRSs</i> <i>CU</i>
1	Property, plant and equipment	8,299	100	8,399
2	Goodwill	1,220	150	1,370
2	Intangible assets	208	(150)	58
3	Financial assets	3,471	420	3,891
	Total non-current assets	13,198	520	13,718
	Trade and other receivables	3,710	0	3,710
4	Inventories	2,962	400	3,362
5	Other receivables	333	431	764
	Cash and cash equivalents	748	0	748
	Total current assets	7,753	831	8,584
	Total assets	20,951	1,351	22,302

continued...

*...continued***IG Example 11 Reconciliation of equity and total comprehensive income**

	Interest-bearing loans	9,396	0	9,396
	Trade and other payables	4,124	0	4,124
6	Employee benefits	0	66	66
7	Restructuring provision	250	(250)	0
	Current tax liability	42	0	42
8	Deferred tax liability	579	460	1,039
	Total liabilities	14,391	276	14,667
	Total assets less total liabilities	6,560	1,075	7,635
	Issued capital	1,500	0	1,500
3	~~Revaluation surplus~~	~~0~~	~~294~~	~~294~~
	~~Hedging reserve~~			
5	<u>Cash flow hedge</u>	0	302	302
9	Retained earnings	5,060	~~773,479~~	~~5,833,539~~
	Total equity	6,560	1,075	7,635

Notes to the reconciliation of equity at 1 January 20X4:

- Depreciation was influenced by tax requirements in accordance with previous GAAP, but in accordance with IFRSs reflects the useful life of the assets. The cumulative adjustment increased the carrying amount of property, plant and equipment by CU100.
- Intangible assets in accordance with previous GAAP included CU150 for items that are transferred to goodwill because they do not qualify for recognition as intangible assets in accordance with IFRSs.
- Financial assets are all classified as at fair value through profit or loss available for sale in accordance with IFRSs and are carried at their fair value of CU3,891. They were carried at cost of CU3,471 in accordance with previous GAAP. The resulting gains of CU294 (CU420, less related deferred tax of CU126) are included in the retained earnings ~~revaluation surplus~~.
- Inventories include fixed and variable production overhead of CU400 in accordance with IFRSs, but this overhead was excluded in accordance with previous GAAP.
- Unrealised gains of CU431 on unmatured forward foreign exchange contracts are recognised in accordance with IFRSs, but were not recognised in accordance with previous GAAP. The resulting gains of CU302 (CU431, less related deferred tax of CU129) are included in the cash flow hedge ~~hedging reserve~~ because the contracts hedge forecast sales.

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IG Example 11 Reconciliation of equity and total comprehensive income

6 A pension liability of CU66 is recognised in accordance with IFRSs, but was not recognised in accordance with previous GAAP, which used a cash basis.

7 A restructuring provision of CU250 relating to head office activities was recognised in accordance with previous GAAP, but does not qualify for recognition as a liability in accordance with IFRSs.

8 The above changes increased the deferred tax liability as follows:

	CU
Revaluation surplus (note 3)	~~126~~
<u>Cash flow hedge Hedging-reserve (note 5)</u>	129
Retained earnings	~~331,205~~
Increase in deferred tax liability	<u>460</u>

Because the tax base at 1 January 20X4 of the items reclassified from intangible assets to goodwill (note 2) equalled their carrying amount at that date, the reclassification did not affect deferred tax liabilities.

9 The adjustments to retained earnings are as follows:

	CU
Depreciation (note 1)	100
<u>Financial assets (note 3)</u>	~~420~~
Production overhead (note 4)	400
Pension liability (note 6)	(66)
Restructuring provision (note 7)	250
Tax effect of the above	~~(331,205)~~
Total adjustment to retained earnings	<u>~~773,479~~</u>

Reconciliation of total comprehensive income for 20X4

Note	Previous GAAP CU	Effect of transition to IFRSs CU	IFRSs CU
Revenue	20,910	0	20,910
1,2,3 Cost of sales	<u>(15,283)</u>	<u>(97)</u>	<u>(15,380)</u>
Gross profit	5,627	(97)	5,530
6 <u>Other income</u>	<u>0</u>	<u>180</u>	<u>180</u>

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IG Example 11 Reconciliation of equity and total comprehensive income

1	Distribution costs	(1,907)	(30)	(1,937)
1,4	Administrative expenses	(2,842)	(300)	(3,142)
	Finance income	1,446	0	1,446
	Finance costs	<u>(1,902)</u>	<u>0</u>	<u>(1,902)</u>
	Profit before tax	422	~~(247)~~ 427	~~175~~ (5)
5	Tax expense	<u>(158)</u>	<u>~~74~~128</u>	<u>~~(84)~~30</u>
	Profit (loss) for the year	264	<u>~~(173)~~299</u>	<u>~~91~~(35)</u>
~~6~~	~~Available for sale financial assets~~	~~0~~	~~150~~	~~150~~
7	Cash flow hedges	0	(40)	(40)
8	Tax relating to other comprehensive income	<u>0</u>	<u>(29)</u>	<u>(29)</u>
	Other comprehensive income	<u>0</u>	<u>~~(69)~~81</u>	<u>~~(69)~~81</u>
	Total comprehensive income	<u>264</u>	<u>~~(242)~~218</u>	<u>~~224~~6</u>

Notes to the reconciliation of total comprehensive income for 20X4:

- 1 A pension liability is recognised in accordance with IFRSs, but was not recognised in accordance with previous GAAP. The pension liability increased by CU130 during 20X4, which caused increases in cost of sales (CU50), distribution costs (CU30) and administrative expenses (CU50).
- 2 Cost of sales is higher by CU47 in accordance with IFRSs because inventories include fixed and variable production overhead in accordance with IFRSs but not in accordance with previous GAAP.
- 3 Depreciation was influenced by tax requirements in accordance with previous GAAP, but reflects the useful life of the assets in accordance with IFRSs. The effect on the profit for 20X4 was not material.

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IG Example 11 Reconciliation of equity and total comprehensive income

- 4 A restructuring provision of CU250 was recognised in accordance with previous GAAP at 1 January 20X4, but did not qualify for recognition in accordance with IFRSs until the year ended 31 December 20X4. This increases administrative expenses for 20X4 in accordance with IFRSs.
- 5 Adjustments 1–4 above lead to a reduction of CU128 in deferred tax expense.
- 6 ~~Available for sale financial assets carried at fair value through profit or loss in accordance with IFRSs increased in value by CU180 during 20X4. They were carried at cost in accordance with previous GAAP. Fair value changes have been included in 'Other income'. The entity sold available for sale financial assets during the year, recognising a gain of CU40 in profit or loss. Of that realised gain CU30 had been included in the revaluation surplus as at 1 January 20X4 and is reclassified from revaluation surplus to profit or loss (as a reclassification adjustment).~~
- 7 The fair value of forward foreign exchange contracts that are effective hedges of forecast transactions decreased by CU40 during 20X4.
- 8 Adjustments 6 and 7 above lead to an increase of CU29 in deferred tax expense.

Explanation of material adjustments to the statement of cash flows for 20X4:

Income taxes of CU133 paid during 20X4 are classified as operating cash flows in accordance with IFRSs, but were included in a separate category of tax cash flows in accordance with previous GAAP. There are no other material differences between the statement of cash flows presented in accordance with IFRSs and the statement of cash flows presented in accordance with previous GAAP.

IFRS 2 *Share-based Payment*

- IG64 A first-time adopter is encouraged, but not required, to apply IFRS 2 *Share-based Payment* to equity instruments that were granted after 7 November 2002 that vested before the later of (a) the date of transition to IFRSs and (b) 1 January 2005.
- IG65 For example, if an entity's date of transition to IFRSs is 1 January 2004, the entity applies IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested at 1 January 2005. Conversely, if an entity's date of transition to IFRSs is 1 January 2010, the entity applies IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested at 1 January 2010.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

- IG66 Paragraph B10 of the IFRS requires a first-time adopter to use its previous GAAP carrying amount of government loans existing at the date of transition to IFRS as the IFRS carrying amount of such loans at that date. A first-time adopter applies IAS 32 *Financial Instruments: Presentation* to classify such a loan as a financial liability or an equity instrument. Subsequently, the first-time adopter applies IFRS 9 to such a loan. To do so, the entity calculates the effective interest rate by comparing the carrying amount of the loan at the date of transition to IFRSs with the amount and timing of expected repayments to the government. IG Example 12 illustrates accounting for such a loan.

[Paragraphs IG67–IG200 reserved for possible guidance on future standards]

IG Example 12 Government loan at a below-market rate of interest at the date of transition to IFRSs

To encourage entities to expand their operations in a specified development zone where it is difficult for entities to obtain financing for their projects, the government provides loans at a below-market rate of interest to fund the purchase of manufacturing equipment.

Entity S's date of transition to IFRSs is 1 January 20X2.

In accordance with the development scheme, in 20X0 Entity S receives a loan at a below-market rate of interest from the government for CU100,000. Under previous GAAP, Entity S accounted for the loan as equity and the carrying amount under previous GAAP was CU100,000 at the date of transition to IFRSs. The amount repayable will be CU103,030 at 1 January 20X5.

No other payment is required under the terms of the loan and there are no future performance conditions attached to the loan. The information needed to measure the fair value of the loan was not obtained at the time of initially accounting for the loan.

The loan meets the definition of a financial liability in accordance with IAS 32. Entity S therefore reclassifies the government loan as a liability. It also uses the previous GAAP carrying amount of the loan at the date of transition to IFRSs as the carrying amount of the loan in the opening IFRS statement of financial position. Entity S therefore reclassifies the amount of CU100,000 from equity to liability in the opening IFRS statement of financial position. In order to measure the loan after the date of transition to IFRSs, the effective interest rate starting 1 January 20X2 is calculated as below:

$$= 3 \sqrt[3]{\left(\frac{103,030}{100,000}\right)} - 1$$

= 0.01

The carrying amounts of the loan are as follows:

Date	Carrying amount	Interest expense	Interest payable
	CU	CU	CU
1 January 20X2	100,000		
31 December 20X2	101,000	1,000	1,000
31 December 20X3	102,010	1,010	2,010
31 December 20X4	103,030	1,020	3,030

IFRIC Interpretations

IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*

- IG201 IAS 16 requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located. IAS 37 requires the liability, both initially and subsequently, to be measured at the amount required to settle the present obligation at the end of the reporting period, reflecting a current market-based discount rate.

- IG202 IFRIC 1 requires that, subject to specified conditions, changes in an existing decommissioning, restoration or similar liability are added to or deducted from the cost of the related asset. The resulting depreciable amount of the asset is depreciated over its useful life, and the periodic unwinding of the discount on the liability is recognised in profit or loss as it occurs.
- IG203 Paragraph D21 of IFRS 1 provides a transitional exemption. Instead of retrospectively accounting for changes in this way, entities can include in the depreciated cost of the asset an amount calculated by discounting the liability at the date of transition to IFRSs back to, and depreciating it from, when the liability was first incurred. IG Example 201 illustrates the effect of applying this exemption, assuming that the entity accounts for its property, plant and equipment using the cost model.

IG Example 201 Changes in existing decommissioning, restoration and similar liabilities

Background

An entity's first IFRS financial statements are for a period that ends on 31 December 20X5 and include comparative information for 20X4 only. Its date of transition to IFRSs is therefore 1 January 20X4.

The entity acquired an energy plant on 1 January 20X1, with a life of 40 years.

As at the date of transition to IFRSs, the entity estimates the decommissioning cost in 37 years' time to be 470, and estimates that the appropriate risk-adjusted discount rate for the liability is 5 per cent. It judges that the appropriate discount rate has not changed since 1 January 20X1.

Application of requirements

The decommissioning liability recognised at the transition date is CU77 (CU470 discounted for 37 years at 5 per cent).

Discounting this liability back for a further three years to 1 January 20X1 gives an estimated liability at acquisition, to be included in the cost of the asset, of CU67. Accumulated depreciation on the asset is $CU67 \times 3/40 = CU5$.

The amounts recognised in the opening IFRS statement of financial position on the date of transition to IFRSs (1 January 20X4) are, in summary:

	CU
Decommissioning cost included in cost of plant	67
Accumulated depreciation	(5)
Decommissioning liability	(77)
Net assets/retained earnings	(15)

IFRIC 4 *Determining whether an Arrangement contains a Lease*

- IG204 IFRIC 4 specifies criteria for determining, at the inception of an arrangement, whether the arrangement contains a lease. It also specifies when an arrangement should be reassessed subsequently.

- IG205 Paragraph D9 of the IFRS provides a transitional exemption. Instead of determining retrospectively whether an arrangement contains a lease at the inception of the arrangement and subsequently reassessing that arrangement as required in the periods before transition to IFRSs, entities may determine whether arrangements in existence on the date of transition to IFRSs contain leases by applying paragraphs 6–9 of IFRIC 4 to those arrangements on the basis of facts and circumstances existing on that date.

IG Example 202 Determining whether an arrangement contains a lease

Background

An entity's first IFRS financial statements are for a period that ends on 31 December 20Y7 and include comparative information for 20Y6 only. Its date of transition to IFRSs is therefore 1 January 20Y6.

On 1 January 20X5 the entity entered into a take-or-pay arrangement to supply gas. On 1 January 20Y0, there was a change in the contractual terms of the arrangement.

Application of requirements

On 1 January 20Y6 the entity may determine whether the arrangement contains a lease by applying the criteria in paragraphs 6–9 of IFRIC 4 on the basis of facts and circumstances existing on that date. Alternatively, the entity applies those criteria on the basis of facts and circumstances existing on 1 January 20X5 and reassesses the arrangement on 1 January 20Y0. If the arrangement is determined to contain a lease, the entity follows the guidance in paragraphs IG14–IG16.

- IG206 Paragraph D9A of IFRS 1 provides a transitional exemption in addition to that discussed in paragraph IG205. The exemption in paragraph D9A applies only to arrangements that were assessed in the same manner as required by IFRIC 4. If arrangements exist at the date of transition to IFRSs that an entity did not assess under previous GAAP in the same manner as required by IFRIC 4 to determine whether they contain a lease, the entity may apply the transition exemption discussed in paragraph IG205.

Table of Concordance

This table shows how the contents of the superseded version of HKFRS 1 and the revised version of HKFRS 1 correspond.

Superseded HKFRS 1 paragraph	Revised HKFRS 1 paragraph	Superseded HKFRS 1 paragraph	Revised HKFRS 1 paragraph	Superseded HKFRS 1 paragraph	Revised HKFRS 1 paragraph
1	1	26	B1	47G	35
2	2	27	B2	47H	None
3	3	27A	B3	47I	36
4	4	28	B4	47J	37
5	5	29	B5	47K	38
6	6	30	B6	47L	39
7	7	31	14	Appendix A	Appendix A
8	8	32	15	Appendix B	Appendix C
9	9	33	16	None	13
10	10	34	17	None	18
11	11	34A	None	None	40
12	12	34B	None		
13	D1	34C	B7		
14	19	35	20		
15	None	36	21		
16	D5	36A	None		
17	D6	36B	None		
18	D7	36C	None		
19	D8	37	22		
20	D10	38	23		
20A	D11	39	24		
21	D12	40	25		
22	D13	41	26		
23	D18	42	27		
23A	D14	43	28		
23B	D15	43A	29		
24	D16	44	30		
25	D17	44A	31		
25A	D19	45	32		
25B	D2	46	33		
25C	D3	47	34		
25D	D4	47A	None		
25E	D21	47B	None		
25F	D9	47C	None		
25G	D20	47D	None		
25H	D22	47E	None		
25I	D23	47F	None		

HKFRS 2
Revised November 2016 September 2018

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Financial Reporting Standard 2

Share-based Payment



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 2 *Share-based Payment* (HKFRS 2) is set out in paragraphs 1-64 and Appendices A-C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. HKFRS 2 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

- (b) has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services

unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them.

- 4 For the purposes of this HKFRS, a transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction. For example, if an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirements of this HKFRS.
- 5 As noted in paragraph 2, this HKFRS applies to share-based payment transactions in which an entity acquires or receives goods or services. Goods includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. However, an entity shall not apply this HKFRS to transactions in which the entity acquires goods as part of the net assets acquired in a business combination as defined by HKFRS 3 *Business Combinations* (as revised in 2008), in a combination of entities or businesses under common control as described in paragraphs B1–B4 of HKFRS 3, or the contribution of a business on the formation of a joint venture as defined by HKFRS 11 *Joint Arrangements*. Hence, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of this HKFRS. However, equity instruments granted to employees of the acquiree in their capacity as employees (e.g. in return for continued service) are within the scope of this HKFRS. Similarly, the cancellation, replacement or other modification of *share-based payment arrangements* because of a business combination or other equity restructuring shall be accounted for in accordance with this HKFRS. HKFRS 3 provides guidance on determining whether equity instruments issued in a business combination are part of the consideration transferred in exchange for control of the acquiree (and therefore within the scope of HKFRS 3) or are in return for continued service to be recognised in the post-combination period (and therefore within the scope of this HKFRS).
- 6 This HKFRS does not apply to share-based payment transactions in which the entity receives or acquires goods or services under a contract within the scope of paragraphs 8-10 of HKAS 32 *Financial Instruments: Presentation** or paragraphs 5–7 ~~2.4–2.7~~ of ~~HKAS 39~~ HKFRS 9 *Financial Instruments: Recognition and Measurement*.
- 6A This HKFRS uses the term ‘fair value’ in a way that differs in some respects from the definition of fair value in HKFRS 13 *Fair Value Measurement*. Therefore, when applying HKFRS 2 an entity measures fair value in accordance with this HKFRS, not HKFRS 13.

Recognition

- 7 **An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.**

* The title of HKAS 32 was amended in 2005.

- 13 To apply the requirements of paragraph 10 to transactions with parties other than employees, there shall be a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. That fair value shall be measured at the date the entity obtains the goods or the counterparty renders service. In rare cases, if the entity rebuts this presumption because it cannot estimate reliably the fair value of the goods or services received, the entity shall measure the goods or services received, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders service.
- 13A In particular, if the identifiable consideration received (if any) by the entity appears to be less than the fair value of the equity instruments granted or liability incurred, typically this situation indicates that other consideration (ie unidentifiable goods or services) has been (or will be) received by the entity. The entity shall measure the identifiable goods or services received in accordance with this HKFRS. The entity shall measure the unidentifiable goods or services received (or to be received) as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services received (or to be received). The entity shall measure the unidentifiable goods or services received at the grant date. However, for cash-settled transactions, the liability shall be remeasured at the end of each reporting period until it is settled in accordance with paragraphs 30–33.

Transactions in which services are received

- 14 If the equity instruments granted *vest* immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In the absence of evidence to the contrary, the entity shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the entity shall recognise the services received in full, with a corresponding increase in equity.
- 15 If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the *vesting period*. The entity shall account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity. For example:
- (a) if an employee is granted share options conditional upon completing three years' service, then the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.
 - (b) if an employee is granted share options conditional upon the achievement of a *performance condition* and remaining in the entity's employ until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a *market condition*, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently

revised. If the performance condition is not a market condition, the entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Transactions measured by reference to the fair value of the equity instruments granted

Determining the fair value of equity instruments granted

- 16 For transactions measured by reference to the fair value of the equity instruments granted, an entity shall measure the fair value of equity instruments granted at the *measurement date*, based on market prices if available, taking into account the terms and conditions upon which those equity instruments were granted (subject to the requirements of paragraphs 19–22).
- 17 If market prices are not available, the entity shall estimate the fair value of the equity instruments granted using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties. The valuation technique shall be consistent with generally accepted valuation methodologies for pricing financial instruments, and shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 19–22).
- 18 Appendix B contains further guidance on the measurement of the fair value of shares and share options, focusing on the specific terms and conditions that are common features of a grant of shares or share options to employees.

Treatment of vesting conditions

- 19 A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employ for a specified period of time. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions, other than market conditions, shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a *vesting condition*, other than a market condition, ~~for example, e.g.~~—the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 21.

Cash-settled share-based payment transactions

- 30 For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability, **subject to the requirements of paragraphs 31–33D**. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.
- 31 For example, an entity might grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time. ~~Or~~ Alternatively, an entity might 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 (e.g. ~~for example~~, upon cessation of employment) or at the employee's option. These arrangements are examples of cash-settled share-based payment transactions. Share appreciation rights are used to illustrate some of the requirements in paragraphs 32–33D; however, the requirements in those paragraphs apply to all cash-settled share-based payment transactions.
- 32 The entity shall recognise the services received, and a liability to pay for those services, as the employees render service. For example, some share appreciation rights vest immediately, and the employees are therefore not required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, the entity shall presume that the services rendered by the employees in exchange for the share appreciation rights have been received. Thus, the entity shall recognise immediately the services received and a liability to pay for them. If the share appreciation rights do not vest until the employees have completed a specified period of service, the entity shall recognise the services received, and a liability to pay for them, as the employees render service during that period.
- 33 The liability shall be measured, initially and at the end of each reporting period until settled, at the fair value of the share appreciation rights, by applying an option pricing model, taking into account the terms and conditions on which the share appreciation rights were granted, and the extent to which the employees have rendered service to date. ~~—subject to the requirements of paragraphs 33A–33D. An entity might modify the terms and conditions on which a cash-settled share-based payment is granted. Guidance for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled is given in paragraphs B44A–B44C in Appendix B.~~

Treatment of vesting and non-vesting conditions

- 33A A cash-settled share-based payment transaction might be conditional upon satisfying specified vesting conditions. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the cash-settled share-based payment at the measurement date. Instead, vesting conditions, other than market conditions, shall be taken into account by adjusting the number of awards included in the measurement of the liability arising from the transaction.
- 33B To apply the requirements in paragraph 33A, the entity shall recognise an amount for

the goods or services received during the vesting period. That amount shall be based on the best available estimate of the number of awards that are expected to vest. The entity shall revise that estimate, if necessary, if subsequent information indicates that the number of awards that are expected to vest differs from previous estimates. On the vesting date, the entity shall revise the estimate to equal the number of awards that ultimately vested.

33C Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, as well as non-vesting conditions, shall be taken into account when estimating the fair value of the cash-settled share-based payment granted and when remeasuring the fair value at the end of each reporting period and at the date of settlement.

33D As a result of applying paragraphs 30–33C, the cumulative amount ultimately recognised for goods or services received as consideration for the cash-settled share-based payment is equal to the cash that is paid.

Share-based payment transactions with a net settlement feature for withholding tax obligations

33E Tax laws or regulations may oblige an entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount, normally in cash, to the tax authority on the employee's behalf. To fulfil this obligation, the terms of the share-based payment arrangement may permit or require the entity to withhold the number of equity instruments equal to the monetary value of the employee's tax obligation from the total number of equity instruments that otherwise would have been issued to the employee upon exercise (or vesting) of the share-based payment (ie the share-based payment arrangement has a 'net settlement feature').

33F As an exception to the requirements in paragraph 34, the transaction described in paragraph 33E shall be classified in its entirety as an equity-settled share-based payment transaction if it would have been so classified in the absence of the net settlement feature.

33G The entity applies paragraph 29 of this Standard to account for the withholding of shares to fund the payment to the tax authority in respect of the employee's tax obligation associated with the share-based payment. Therefore, the payment made shall be accounted for as a deduction from equity for the shares withheld, except to the extent that the payment exceeds the fair value at the net settlement date of the equity instruments withheld.

33H The exception in paragraph 33F does not apply to:

- (a) a share-based payment arrangement with a net settlement feature for which there is no obligation on the entity under tax laws or regulations to withhold an amount for an employee's tax obligation associated with that share-based payment; or
- (b) any equity instruments that the entity withholds in excess of the employee's tax obligation associated with the share-based payment (ie the entity withheld an amount of shares that exceeds the monetary value of the employee's tax obligation). Such excess shares withheld shall be accounted for as a cash-settled share-based payment when this amount is paid in cash (or other assets) to the employee.

Share-based payment transactions with cash alternatives

34 For share-based payment transactions in which the terms of the arrangement

provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity shall account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

- (i) if fair value was not measured on the basis of an observable market price, how it was determined;
 - (ii) whether and how expected dividends were incorporated into the measurement of fair value; and
 - (iii) whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value.
 - (c) for share-based payment arrangements that were modified during the period:
 - (i) an explanation of those modifications;
 - (ii) the incremental fair value granted (as a result of those modifications); and
 - (iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.
- 48 If the entity has measured directly the fair value of goods or services received during the period, the entity shall disclose how that fair value was determined, e.g. whether fair value was measured at a market price for those goods or services.
- 49 If the entity has rebutted the presumption in paragraph 13, it shall disclose that fact, and give an explanation of why the presumption was rebutted.
- 50 An entity shall disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.**
- 51 To give effect to the principle in paragraph 50, the entity shall disclose at least the following:
- (a) the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions;
 - (b) for liabilities arising from share-based payment transactions:
 - (i) the total carrying amount at the end of the period; and
 - (ii) 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 (e.g. vested share appreciation rights).
- 52 If the information required to be disclosed by this ~~HKFRS Standard~~ does not satisfy the principles in paragraphs 44, 46 and 50, the entity shall disclose such additional information as is necessary to satisfy them. For example, if an entity has classified any share-based payment transactions as equity-settled in accordance with paragraph 33F, the entity shall disclose an estimate of the amount that it expects to transfer to

the tax authority to settle the employee's tax obligation when it is necessary to inform users about the future cash flow effects associated with the share-based payment arrangement.

Transitional provisions

- 53 For equity-settled share-based payment transactions, the entity shall apply this HKFRS to grants of shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested at the effective date of this HKFRS.
 - 54 The entity is encouraged, but not required, to apply this HKFRS to other grants of equity instruments if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date.
 - 55 For all grants of equity instruments to which this HKFRS is applied, the entity shall restate comparative information and, where applicable, adjust the opening balance of retained earnings for the earliest period presented.
 - 56 For all grants of equity instruments to which this HKFRS has not been applied (e.g. equity instruments granted on or before 7 November 2002), the entity shall nevertheless disclose the information required by paragraphs 44 and 45.
 - 57 If, after the HKFRS becomes effective, an entity modifies the terms or conditions of a grant of equity instruments to which this HKFRS has not been applied, the entity shall nevertheless apply paragraphs 26–29 to account for any such modifications.
 - 58 For liabilities arising from share-based payment transactions existing at the effective date of this HKFRS, the entity shall apply the HKFRS retrospectively. For these liabilities, the entity shall restate comparative information, including adjusting the opening balance of retained earnings in the earliest period presented for which comparative information has been restated, except that the entity is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.
 - 59 The entity is encouraged, but not required, to apply retrospectively the HKFRS to other liabilities arising from share-based payment transactions, for example, to liabilities that were settled during a period for which comparative information is presented.
- 59A An entity shall apply the amendments in paragraphs 30–31, 33–33H and B44A–B44C as set out below. Prior periods shall not be restated.
- (a) The amendments in paragraphs B44A–B44C apply only to modifications that occur on or after the date that an entity first applies the amendments.
 - (b) The amendments in paragraphs 30–31 and 33–33D apply to share-based payment transactions that are unvested at the date that an entity first applies the amendments and to share-based payment transactions with a grant date on or after the date that an entity first applies the amendments. For unvested share-based payment transactions granted prior to the date that an entity first applies the amendments, an entity shall remeasure the liability at that date and recognise the effect of the remeasurement in opening retained earnings (or other component of equity, as appropriate) of the reporting period in which the amendments are first applied.

- (c) The amendments in paragraphs 33E–33H and the amendment to paragraph 52 apply to share-based payment transactions that are unvested (or vested but unexercised), at the date that an entity first applies the amendments and to share-based payment transactions with a grant date on or after the date that an entity first applies the amendments. For unvested (or vested but unexercised) share-based payment transactions (or components thereof) that were previously classified as cash-settled share-based payments but now are classified as equity-settled in accordance with the amendments, an entity shall reclassify the carrying value of the share-based payment liability to equity at the date that it first applies the amendments.

59B Notwithstanding the requirements in paragraph 59A, an entity may apply the amendments in paragraph 63D retrospectively, subject to the transitional provisions in paragraphs 53–59 of this Standard, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* if and only if it is possible without hindsight. If an entity elects retrospective application, it must do so for all of the amendments made by *Classification and Measurement of Share-based Payment Transactions* (Amendments to HKFRS 2).

Effective date

- 60 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies the HKFRS for a period beginning before 1 January 2005, it shall disclose that fact.
- 61[†] HKFRS 3 (as revised in 2008) and *Improvements to HKFRSs* issued in May 2009 amended paragraph 5. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. Earlier application is permitted. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 62 An entity shall apply the following amendments retrospectively in annual periods beginning on or after 1 January 2009:
- (a) the requirements in paragraph 21A in respect of the treatment of non-vesting conditions;
 - (b) the revised definitions of ‘vest’ and ‘vesting conditions’ in Appendix A;
 - (c) the amendments in paragraphs 28 and 28A in respect of cancellations.
- Earlier application is permitted. If an entity applies these amendments for a period beginning before 1 January 2009, it shall disclose that fact.
- 63 An entity shall apply the following amendments made by *Group Cash-settled Share-based Payment Transactions* issued in July 2009 retrospectively, subject to the transitional provisions in paragraphs 53–59, in accordance with HKAS 8 ~~*Accounting Policies, Changes in Accounting Estimates and Errors*~~ for annual periods beginning on or after 1 January 2010:
- (a) the amendment of paragraph 2, the deletion of paragraph 3 and the addition of paragraphs 3A and 43A–43D and of paragraphs B45, B47, B50, B54, B56–B58 and B60 in Appendix B in respect of the accounting for transactions

[†] Amendments effective for annual periods beginning on or after 1 July 2009.

among group entities.

- (b) the revised definitions in Appendix A of the following terms:
- cash-settled share-based payment transaction,
 - equity-settled share-based payment transaction,
 - share-based payment arrangement, and
 - share-based payment transaction.

If the information necessary for retrospective application is not available, an entity shall reflect in its separate or individual financial statements the amounts previously recognised in the group's consolidated financial statements. Earlier application is permitted. If an entity applies the amendments for a period beginning before 1 January 2010, it shall disclose that fact.

63A HKFRS 10 *Consolidated Financial Statements* and HKFRS 11, issued in June 2011, amended paragraph 5 and Appendix A. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.

63B *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 15 and 19. In Appendix A, the definitions of 'vesting conditions' and 'market condition' were amended and the definitions of 'performance condition' and 'service condition' were added. An entity shall prospectively apply that amendment to share-based payment transactions for which the grant date is on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

63C HKFRS 9, as issued in September 2014, amended paragraph 6. An entity shall apply that amendment when it applies HKFRS 9.

63D *Classification and Measurement of Share-based Payment Transactions (Amendments to HKFRS 2)*, issued in August 2016, amended paragraphs 19, 30–31, 33, 52 and 63 and added paragraphs 33A–33H, 59A–59B, 63D and B44A–B44C and their related headings. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.

Withdrawal of Interpretations

64 *Group Cash-settled Share-based Payment Transactions* issued in July 2009 supersedes HK(IFRIC)-Int 8 *Scope of HKFRS 2* and HK(IFRIC)-Int 11 *HKFRS 2—Group and Treasury Share Transactions*. The amendments made by that document incorporated the previous requirements set out in HK(IFRIC)-Int 8 and HK(IFRIC)-Int 11 as follows:

- (a) amended paragraph 2 and added paragraph 13A in respect of the accounting for transactions in which the entity cannot identify specifically some or all of the goods or services received. Those requirements were effective for annual periods beginning on or after 1 May 2006.
- (b) added paragraphs B46, B48, B49, B51–B53, B55, B59 and B61 in Appendix B in respect of the accounting for transactions among group entities. Those requirements were effective for annual periods beginning on or after 1 March 2007.

Those requirements were applied retrospectively in accordance with the requirements of HKAS 8, subject to the transitional provisions of HKFRS 2.

share-based payment arrangement	An agreement between the entity (or another group^(a) entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive (a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or (b) equity instruments (including shares or share options) of the entity or another group entity, provided the specified vesting conditions, if any, are met.
share-based payment transaction	A transaction in which the entity (a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or (b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.
share option	A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.
vest	To become an entitlement. Under a share-based payment arrangement , a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions .
vesting conditions	A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement . A vesting condition is either a service condition or a performance condition .
vesting period	The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

^(a) A 'group' is defined in Appendix A of HKFRS 10 *Consolidated Financial Statements* as 'a parent and its subsidiaries' from the perspective of the reporting entity's ultimate parent.

- (c) if the entity modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the entity shall take the modified vesting conditions into account when applying the requirements of paragraphs 19–21.

B44 Furthermore, if the entity modifies the terms or conditions of the equity instruments granted in a manner that reduces the total fair value of the share-based payment arrangement, or is not otherwise beneficial to the employee, the entity shall nevertheless continue to account for the services received as consideration for the equity instruments granted as if that modification had not occurred (other than a cancellation of some or all the equity instruments granted, which shall be accounted for in accordance with paragraph 28). For example:

- (a) if the modification reduces the fair value of the equity instruments granted, measured immediately before and after the modification, the entity shall not take into account that decrease in fair value and shall continue to measure the amount recognised for services received as consideration for the equity instruments based on the grant date fair value of the equity instruments granted.
- (b) if the modification reduces the number of equity instruments granted to an employee, that reduction shall be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 28.
- (c) if the entity modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the entity shall not take the modified vesting conditions into account when applying the requirements of paragraphs 19–21.

Accounting for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled

B44A If the terms and conditions of a cash-settled share-based payment transaction are modified with the result that it becomes an equity-settled share-based payment transaction, the transaction is accounted for as such from the date of the modification. Specifically:

- (a) The equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted at the modification date. The equity-settled share-based payment transaction is recognised in equity on the modification date to the extent to which goods or services have been received.
- (b) The liability for the cash-settled share-based payment transaction as at the modification date is derecognised on that date.
- (c) Any difference between the carrying amount of the liability derecognised and the amount of equity recognised on the modification date is recognised immediately in profit or loss.

B44B If, as a result of the modification, the vesting period is extended or shortened, the application of the requirements in paragraph B44A reflect the modified vesting period. The requirements in paragraph B44A apply even if the modification occurs after the vesting period.

B44C A cash-settled share-based payment transaction may be cancelled or settled (other than a transaction cancelled by forfeiture when the vesting conditions are not satisfied). If equity instruments are granted and, on that grant date, the entity identifies them as a replacement for the cancelled cash-settled share-based payment, the entity shall apply paragraphs B44A and B44B.

Share-based payment transactions among group entities (2009 amendments)*

B45 Paragraphs 43A–43C address the accounting for share-based payment transactions among group entities in each entity’s separate or individual financial statements. Paragraphs B46–B61 discuss how to apply the requirements in paragraphs 43A–43C. As noted in paragraph 43D, share-based payment transactions among group entities may take place for a variety of reasons depending on facts and circumstances. Therefore, this discussion is not exhaustive and assumes that when the entity receiving the goods or services has no obligation to settle the transaction, the transaction is a parent’s equity contribution to the subsidiary, regardless of any intragroup repayment arrangements.

B46 Although the discussion below focuses on transactions with employees, it also applies to similar share-based payment transactions with suppliers of goods or services other than employees. An arrangement between a parent and its subsidiary may require the subsidiary to pay the parent for the provision of the equity instruments to the employees. The discussion below does not address how to account for such an intragroup payment arrangement.

* Amendments effective for annual periods beginning on or after 1 January 2010.

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 2*

Share-based Payment



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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- BC24B The Board was advised that the changes to that definition caused the accounting for the contribution of a business in exchange for shares issued on formation of a joint venture by the venturers to be within the scope of IFRS 2. The Board noted that common control transactions may also be within the scope of IFRS 2 depending on which level of the group reporting entity is assessing the combination.
- BC24C The Board noted that during the development of revised IFRS 3 it did not discuss whether it intended IFRS 2 to apply to these types of transactions. The Board also noted that the reason for excluding common control transactions and the accounting by a joint venture upon its formation from the scope of revised IFRS 3 was to give the Board more time to consider the relevant accounting issues. When the Board revised IFRS 3, it did not intend to change existing practice by bringing such transactions within the scope of IFRS 2, which does not specifically address them.
- BC24D Accordingly, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 5 of IFRS 2 to confirm that the contribution of a business on the formation of a joint venture and common control transactions are not within the scope of IFRS 2.

Transactions within the scope of IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*[#]

- BC25 The IFRS includes consequential amendments to IAS 32 and IAS 39 (both as revised in 2003)^{*} to exclude from their scope transactions within the scope of IFRS 2.
- BC26 For example, suppose the entity enters into a contract to purchase cloth for use in its clothing manufacturing business, whereby it is required to pay cash to the counterparty in an amount equal to the value of 1,000 of the entity's shares at the date of delivery of the cloth. The entity will acquire goods and pay cash at an amount based on its share price. This meets the definition of a share-based payment transaction. Moreover, because the contract is to purchase cloth, which is a non-financial item, and the contract was entered into for the purpose of taking delivery of the cloth for use in the entity's manufacturing business, the contract is not within the scope of IAS 32 and IAS 39.
- BC27 The scope of IAS 32 and IAS 39 includes contracts to buy non-financial items that can be settled net in cash or another financial instrument, or by exchanging financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. A contract that can be settled net in cash or another financial instrument or by exchanging financial instruments includes (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments; (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts, or by selling the contract before its exercise or lapse); (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and (d) when the non-financial item

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. Paragraphs BC25-BC28 refer to matters relevant when IFRS 2 was issued.

^{*} The title of IAS 32 was amended in 2005.

- (c) there is no cost to the entity, because no cash or other assets are given up; the shareholders bear the cost, in the form of dilution of their ownership interests, not the entity.
- (d) the recognition of an expense is inconsistent with the definition of an expense in the conceptual frameworks used by accounting standard-setters, including the IASB's *Framework for the Preparation and Presentation of Financial Statements*.^{*}
- (e) the cost borne by the shareholders is recognised in the dilution of earnings per share (EPS); if the transaction is recognised in the entity's accounts, the resulting charge to the income statement would mean that EPS is 'hit twice'.
- (f) requiring the recognition of a charge would have adverse economic consequences, because it would discourage entities from introducing or continuing employee share plans.

'The entity is not a party to the transaction'

- BC34 Some argue that the effect of employee share plans is that the existing shareholders transfer some of their ownership interests to the employees and that the entity is not a party to this transaction.
- BC35 The Board did not accept this argument. Entities, not shareholders, set up employee share plans and entities, not shareholders, issue share options to their employees. Even if that were not the case, e.g. if shareholders transferred shares or share options direct to the employees, this would not mean that the entity is not a party to the transaction. The equity instruments are issued in return for services rendered by the employees and the entity, not the shareholders, receives those services. Therefore, the Board concluded that the entity should account for the services received in return for the equity instruments issued. The Board noted that this is no different from other situations in which equity instruments are issued. For example, if an entity issues warrants for cash, the entity recognises the cash received in return for the warrants issued. Although the effect of an issue, and subsequent exercise, of warrants might be described as a transfer of ownership interests from the existing shareholders to the warrant holders, the entity nevertheless is a party to the transaction because it receives resources (cash) for the issue of warrants and further resources (cash) for the issue of shares upon exercise of the warrants. Similarly, with employee share options, the entity receives resources (employee services) for the issue of the options and further resources (cash) for the issue of shares on the exercise of options.

'The employees do not provide services'

- BC36 Some who argue that the entity is not a party to the transaction counter the points made above with the argument that employees do not provide services for the options, because the employees are paid in cash (or other assets) for their services.
- BC37 Again, the Board was not convinced by this argument. If it were true that employees do not provide services for their share options, this would mean that entities are issuing valuable share options and getting nothing in return. Employees do not pay cash for the share options they receive. Hence, if they do not provide services for the options, the employees are providing nothing in return. If this were true, by issuing such options the entity's directors would be in breach of their fiduciary duties to their shareholders.

^{*} References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

BC237A During the deliberations of its proposals in the exposure draft *Vesting Conditions and Cancellations* published in February 2006, the Board considered how failure to meet a non-vesting condition should be treated. The Board concluded that in order to be consistent with the grant date measurement method, failure to meet a non-vesting condition should have no accounting effect when neither the entity nor the counterparty can choose whether that condition is met. The entity should continue to recognise the expense, based on the grant date fair value, over the vesting period unless the employee fails to meet a vesting condition.

BC237B However, the Board concluded that the entity's failure to meet a non-vesting condition is a cancellation if the entity can choose whether that non-vesting condition is met. Furthermore, the Board noted that no non-arbitrary or unambiguous criteria exist to distinguish between a decision by the counterparty not to meet a non-vesting condition and a cancellation by the entity. The Board considered establishing a rebuttable presumption that a counterparty's failure to meet a non-vesting condition is (or is not) a cancellation, unless it can be demonstrated that the entity had no (or had some) influence over the counterparty's decision. The Board did not believe that the information about the entity's decision-making processes that is publicly available would be sufficient to determine whether the presumption has been rebutted. Therefore, the Board concluded that a failure to meet a non-vesting condition should be treated as a cancellation when either the entity or the counterparty can choose whether that non-vesting condition is met.

Accounting for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled (2016 amendments)*

BC237C This section summarises the Board's considerations when finalising its proposals to address the accounting for a modification to the terms and conditions of a share-based payment that changes the classification of the transaction from cash-settled to equity-settled. These changes were proposed in the Exposure Draft *Classification and Measurement of Share-based Payment Transactions* (Proposed amendments to IFRS 2) published in November 2014 (November 2014 ED).

BC237D The Board was informed that there are situations in which a cash-settled share-based payment is modified by cancelling it and replacing it with a new equity-settled share-based payment, and, at the replacement date, the fair value of the replacement award is different from the recognised value of the original award. Interested parties told the Board that there is diversity in practice because IFRS 2 does not provide specific requirements for these situations and asked the Board to clarify the accounting.

BC237E The Board decided that paragraphs 27 and B42–B44 of IFRS 2, which set out the requirements for modifications to the terms and conditions of equity-settled share-based payments, should not be applied by analogy to account for the fact patterns raised. This is because the requirement in paragraph 27 of IFRS 2 to recognise a minimum amount for the equity-settled share-based payment following a modification is inconsistent with the requirement in paragraph 30 of IFRS 2 to remeasure the liability for a cash-settled share-based payment at fair value at the end of each reporting date until the liability is settled.

* Paragraphs BC237C–BC237L are added as a consequence of amendments to IFRS 2 *Classification and Measurement of Share-based Payment Transactions*, issued in June 2016.

BC237F Accordingly, the Board decided to require that the equity-settled share-based payment transaction be recognised in equity to the extent to which goods or services have been received at the modification date. The Board required this measurement to be made by reference to the modification-date fair value of the equity instruments granted. The Board noted that, at the original grant date, there was a shared understanding that the entity would pay cash for services to be rendered by the counterparty. However, at the modification date, the entity and the counterparty have a new shared understanding that the entity will issue equity instruments to the counterparty. Therefore, the Board concluded that the modification-date fair value should be used to measure the modified equity-settled share-based payment.

BC237G Furthermore, the Board noted that the liability for the original cash-settled share-based payment is derecognised on the modification date as it is considered to be settled when the entity grants the replacement equity-settled share-based payment. This is because, at the modification date, the entity is no longer obliged to transfer cash (or other assets) to the counterparty.

BC237H The Board observed that any difference between the carrying amount of the derecognised liability and the amount of recognised equity on the modification date is recognised immediately in profit or loss. The Board observed that this is consistent with how cash-settled share-based payments are measured in accordance with paragraph 30 of IFRS 2. The Board further observed that recognising the difference in value between the original and the replacement award in profit or loss is also consistent with the requirements for the extinguishment of a financial liability (that has been extinguished fully or partially by the issue of equity instruments) in paragraph 3.3.3 of IFRS 9 *Financial Instruments* and with paragraph 9 of IFRIC *Interpretation 19 Extinguishing Financial Liabilities with Equity Instruments*.

BC237I Respondents to the November 2014 ED questioned whether the guidance in paragraph B44A would also apply to a situation in which the modification changes the vesting period of the share-based payment transaction. The Board confirmed in paragraph B44B that the guidance in paragraph B44A is applied when the modification occurs during or after the vesting period, and when the vesting period is extended or shortened.

BC237J The Board provided guidance in paragraph B44C to account for a grant of equity instruments that has been identified as a replacement for a cancelled cash-settled share-based payment. The Board observed that if an entity does not identify a grant of equity instruments as a replacement, the entity would have to reverse the expense recognised for the cash-settled share-based payment and recognise an expense for the new equity-settled share-based payment. The Board noted that this accounting treatment is different from the accounting for modifications of equity-settled awards when the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instrument (as set out in paragraph 28(c) of IFRS 2). In that case, the entity does not reverse the expense recognised for the cancelled original equity-settled award and recognises an expense for the new grant of equity instruments.

BC237K Some respondents to the November 2014 ED suggested that the Board add examples to the implementation guidance of IFRS 2 to illustrate the accounting for other types of modifications of share-based payments (for example, a modification from equity-settled to cash-settled). The Board decided that it was not necessary to include additional examples (other than adding paragraph IG19B and IG Example 12C which

illustrates the application of paragraphs B44A–B44C), because the existing implementation guidance in IFRS 2 could be applied by analogy. For example, Example 9 illustrates a grant of shares to which a cash settlement alternative is subsequently added.

Effective date and transition (2016 amendments)

BC237L In response to the comments received on the November 2014 ED, the Board decided to provide specific transition requirements in paragraph 59A of IFRS 2 for each of the amendments. The Board also decided to permit an entity to apply all of the amendments retrospectively if, (and only if), the necessary information to do so is available without the use of hindsight.

Share appreciation rights settled in cash

BC238 Some transactions are ‘share-based’, even though they do not involve the issue of shares, share options or any other form of equity instrument. Share appreciation rights (SARs) settled in cash are transactions in which the amount of cash paid to the employee (or another party) is based upon the increase in the share price over a specified period, usually subject to vesting conditions, such as the employee’s remaining with the entity during the specified period. (Note that the following discussion focuses on SARs granted to employees, but also applies to SARs granted to other parties.)

BC239 In terms of accounting concepts, share-based payment transactions involving an outflow of cash (or other assets) are different from transactions in which goods or services are received as consideration for the issue of equity instruments.

BC240 In an equity-settled transaction, only one side of the transaction causes a change in assets, i.e. an asset (services) is received but no assets are disbursed. The other side of the transaction increases equity; it does not cause a change in assets. Accordingly, not only is it not necessary to remeasure the transaction amount upon settlement, it is not appropriate, because equity interests are not remeasured.

BC241 In contrast, in a cash-settled transaction, both sides of the transaction cause a change in assets, ie an asset (services) is received and an asset (cash) is ultimately disbursed. Therefore, no matter what value is attributed to the first asset (services received), eventually it will be necessary to recognise the change in assets when the second asset (cash) is disbursed. Thus, no matter how the transaction is accounted for between the receipt of services and the settlement in cash, it will be ‘trued up’ to equal the amount of cash paid out, to account for both changes in assets.

share-based payment transactions, and

- changes in estimate between grant date and settlement date, i.e. all changes required to remeasure the transaction amount to equal the amount paid out on settlement date.

BC253 In developing ED 2, the Board concluded that information about these two components would be helpful to users of financial statements. For example, users of financial statements regard the effects of remeasuring the liability as having little predictive value. Therefore, the Board concluded that there should be separate disclosure, either on the face of the income statement or in the notes, of that portion of the expense recognised during each accounting period that is attributable to changes in the estimated fair value of the liability between grant date and settlement date.

BC254 However, some respondents to ED 2 disagreed with the proposed disclosure, arguing that it was burdensome and inappropriate to require the entity to account for the transaction as a cash-settled transaction and also calculate, for the purposes of the disclosure, what the transaction amount would have been if the arrangement was an equity-settled transaction.

BC255 The Board considered these comments and also noted that its decision to adopt the SFAS 123 modified grant date method will make it more complex for entities to determine the amount to disclose, because it will be necessary to distinguish between the effects of forfeitures and the effects of fair value changes when calculating the amount to disclose. The Board therefore concluded that the disclosure should not be retained as a mandatory requirement, but instead should be given as an example of an additional disclosure that entities should consider providing. For example, entities with a significant amount of cash-settled arrangements that experience significant share price volatility will probably find that the disclosure is helpful to users of their financial statements.

Share-based payment transactions with a net settlement feature for withholding tax obligations (2016 amendments)*

BC255A This section summarises the Board's considerations when it finalised its proposals to address the classification of a share-based payment transaction with a net settlement feature for withholding tax obligations, contained in the November 2014 ED.

BC255B Some jurisdictions have tax laws or regulations that oblige an entity to withhold an amount for an employee's tax obligation associated with a share-based payment and to transfer that amount, normally in cash, to the tax authority on the employee's behalf. Those tax withholding obligations vary from jurisdiction to jurisdiction. To fulfill this obligation, many plans include a net settlement feature that permits or requires the entity to deduct from the total number of equity instruments that it otherwise would deliver to the employee, the number of equity instruments needed to equal the monetary value of the tax obligation that the employee incurs as a result of the share-based payment transaction. The entity transfers the amount withheld to the tax authority in cash or other assets.

* Paragraphs BC255A–BC255P are added as a consequence of amendments to IFRS 2 *Classification and Measurement of Share-based Payment Transactions*, issued in June 2016.

BC255C The Board received a request to address the classification of such a share-based payment transaction. Specifically, the Board was asked whether the portion of the share-based payment that the entity withholds to satisfy the employee's tax obligation should be classified as cash-settled or equity-settled, if the transaction would otherwise have been classified as an equity-settled share-based payment transaction.

BC255D There were two views on this issue:

- (a) View 1—The share-based payment has two components and each component is accounted for consistently with its manner of settlement. The portion that the entity withholds, and for which it incurs a liability to transfer cash (or other assets) to the tax authority, should be accounted for as a cash-settled share-based payment transaction. The portion of the share-based payment that the entity settles by issuing equity instruments to the employee is accounted for as an equity-settled share-based payment.
- (b) View 2—The entire share-based payment transaction should be classified as an equity-settled share-based payment transaction, because the net settlement should be viewed as if the entity had repurchased some of the equity instruments issued to the employee (ie the entity would apply the requirements in paragraph 29 of IFRS 2 for a repurchase of vested equity instruments).

BC255E View 1 is based on the view that the entity is settling part of the share-based payment transaction in cash; ie the entity has an obligation to transfer cash (or other assets) to the tax authority to settle the employee's tax obligation on the employee's behalf. Paragraph 34 of IFRS 2 requires a share-based payment transaction, or components of that transaction, to be classified as cash-settled if, and to the extent that, the entity has incurred a liability to settle in cash or other assets.

BC255F View 2 is based on the view that the entity is acting as an agent when it transfers cash to the tax authority because the employee has the tax obligation. Under this view, it is as if the entity settles the share-based payment transaction in its entirety by issuing equity instruments to the employee. As a separate (yet simultaneous) transaction, the entity repurchases a portion of those equity instruments from the employee. The entity then remits the cash value of the repurchased equity instruments to the tax authority on behalf of the employee to settle the employee's tax obligation in relation to the share-based payment.

BC255G The Board observed that paragraph 34 of IFRS 2 indicates that a share-based payment transaction, or components of that transaction, should be classified as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets. Consequently a transaction with such a net settlement feature would be divided into two components and each component would be accounted for consistently with how it is settled (View 1). Consequently, the component that reflects the entity's obligation to pay cash to the tax authority would be accounted for as a cash-settled share-based payment and the component that reflects the entity's obligation to issue equity instruments to the employee would be accounted for as an equity-settled share-based payment.

BC255H The Board observed that the entity's payment to the tax authority represents, in substance, a payment to the counterparty (ie the employee) for the services received from the counterparty, despite the fact that the entity transfers the cash to the tax authority. This is because:

- (a) when the entity pays the amount withheld to the tax authority on behalf of the employee, the entity is acting as an agent for the employee; however,
- (b) the entity is also acting as a principal because it is fulfilling its obligation to the employee (ie the counterparty in the share-based payment transaction) to transfer cash (or other assets) for the goods or services received.

BC255I Nevertheless, despite the requirements in paragraph 34, the Board decided to make an exception with the result that the transaction would be classified as equity-settled in its entirety if it would have been so classified had it not included the net settlement feature. The Board decided that this exception should be limited to the share-based payment transaction described in paragraph 33E.

BC255J The Board decided to make the exception because it observed that dividing the specific transaction described in paragraph 33E into two components could be a significant operational challenge for preparers and thus impose cost in excess of the benefit of distinguishing the two components. This is because dividing the transaction into two components requires an entity to estimate changes that affect the amount that the entity is required to withhold and remit to the tax authority on the employee's behalf in respect of the share-based payment. As that estimate changes, the entity would need to reclassify a portion of the share-based payment between cash-settled and equity-settled.

BC255K Respondents to the November 2014 ED observed that this ED did not specifically address the accounting for the amount paid by the entity to the tax authority. In response to these concerns the Board decided to explain how the requirements of paragraph 29 of IFRS 2 would be applied. Paragraph 33G explains that the accounting for the amount transferred to the tax authority in respect of the employee's tax obligation associated with the share-based payment is consistent with the accounting described in paragraph 29 of this Standard (ie as if the entity had repurchased the vested equity instruments). This amendment does not address the recognition and measurement of any liability to the tax authority.

BC255L The Board observed that withholding shares to fund the payment (in cash or other assets) to the tax authority could result in a significant difference between the amount paid and the amount at which the share-based payment was measured. This is because the amount payable to the tax authority may reflect settlement-date fair value, whereas the amount recognised for the equity-settled share-based payment during the vesting period would reflect grant-date fair value.

BC255M The Board further observed that it could be necessary to inform users about the future cash flow effects associated with the share-based payment arrangement as the settlement of the tax payment to the tax authority approaches. Therefore, the Board decided to require an entity to disclose the estimated amount that it expects to transfer to the tax authority when this disclosure is needed to inform users about the future cash-flow effects associated with the share-based payment. The Board did not specify the basis for calculating such an estimate.

BC255N The Board also received questions about the accounting when the number of equity instruments withheld exceeds the number of equity instruments needed to equal the monetary value of the employee's tax obligation in respect of the share-based payment. The Board observed that the classification exception (in paragraph 33F) for the classification of a share-based payment award with a net settlement feature would not apply to any equity instruments withheld in excess of the number required to equal the

monetary value of the employee's tax obligation. Consequently, when that excess amount is paid to the employee in cash (or other assets), and consistent with existing requirements, the excess number of equity instruments withheld should be separated and accounted for as a cash-settled share-based payment.

BC255O Some respondents to the November 2014 ED asked the Board to clarify whether the exception in paragraph 33F (ie relief from dividing the share-based payment into its different components) applies to arrangements other than those in which an entity is obliged by tax laws or regulations to withhold an employee's tax obligation. For example, an entity may not be obliged by tax laws or regulations to withhold an amount for an employee's tax obligation but it is the entity's normal practice to withhold such an amount. The Board noted that its intent is to limit the exception to circumstances in which the tax laws or regulations impose the obligation on the entity to withhold an amount for the employee's tax obligation associated with a share-based payment for the exception in paragraph 33F to apply.

BC255P Furthermore, the Board added paragraph IG19A and IG Example 12B to the Guidance on Implementing IFRS 2 to illustrate a share-based payment transaction with a net settlement feature for withholding tax obligations.

Share-based payment transactions with cash alternatives

BC256 Under some employee share-based payment arrangements the employees can choose to receive cash instead of shares or share options, or instead of exercising share options. There are many possible variations of share-based payment arrangements under which a cash alternative may be paid. For example, the employees may have more than one opportunity to elect to receive the cash alternative, e.g. the employees may be able to elect to receive cash instead of shares or share options on vesting date, or elect to receive cash instead of exercising the share options. The terms of the arrangement may provide the entity with a choice of settlement, i.e. whether to pay the cash alternative instead of issuing shares or share options on vesting date or instead of issuing shares upon the exercise of the share options. The amount of the cash alternative may be fixed or variable and, if variable, may be determinable in a manner that is related, or unrelated, to the price of the entity's shares.

BC257 The IFRS contains different accounting methods for cash-settled and equity-settled share-based payment transactions. Hence, if the entity or the employee has the choice of settlement, it is necessary to determine which accounting method should be applied. The Board considered situations when the terms of the arrangement provide (a) the employee with a choice of settlement and (b) the entity with a choice of settlement.

Effects of vesting conditions on the measurement of a cash-settled share-based payment (2016 amendments)*

- BC371 This section summarises the Board’s considerations when it finalised its proposals to address the accounting for the effects of vesting conditions on the measurement of a cash-settled share-based payment, contained in the November 2014 ED.
- BC372 The Board received a request regarding the measurement requirements in IFRS 2 for cash-settled share-based payment transactions that include a performance condition.
- BC373 The Board noted that IFRS 2 requires the use of fair value as a principle in measuring share-based payment transactions. The Board observed that paragraphs 19–21A of IFRS 2 provide the requirements for measuring the fair value of equity-settled share-based payment transactions that include vesting and non-vesting conditions. The Board also observed that, in the case of cash-settled share-based payment transactions, paragraph 33 of IFRS 2 requires an entity to measure the liability, initially and at the end of each reporting period until settled, at fair value. The entity is required to apply an option pricing model, taking into account the terms and conditions on which the cash-settled share-based payments were granted and the extent to which the employees have rendered service to date.
- BC374 However, IFRS 2 does not specifically address the impact of vesting and non-vesting conditions on the measurement of the fair value of the liability incurred in a cash-settled share-based payment transaction. Specifically, it was unclear whether an entity should apply, by analogy, the requirements in paragraphs 19–21A of IFRS 2 for measuring equity-settled share-based payment transactions when measuring cash-settled share-based payment transactions that include vesting and non-vesting conditions.
- BC375 The Board observed that, in accordance with paragraph 6A, IFRS 2 uses the term ‘fair value’ in a way that differs in some respects from the definition of fair value in IFRS 13 *Fair Value Measurement*. When applying IFRS 2, an entity is required to measure fair value in accordance with that Standard (and not in accordance with IFRS 13) for cash-settled and equity-settled awards. Consequently, the Board decided to add paragraphs 33A–33D on how market and non-market vesting conditions and non-vesting conditions should be reflected in the measurement of a cash-settled share-based payment transaction. The Board decided that those conditions should be reflected in the measurement of cash-settled share-based payments in a manner consistent with how they are reflected in the measurement of an equity-settled share-based payment transaction.
- BC376 The Board further observed that measuring the fair value of the liability incurred in a cash-settled share-based payment transaction by analogy to the requirements for equity-settled share-based payment transactions would avoid the practical difficulties of measuring the effects of vesting conditions (other than market conditions) on the fair value of the awards. Those practical difficulties were identified by the Board when it originally issued IFRS 2, and are explained in paragraph BC184 of IFRS 2.

* Paragraphs BC371–BC382 are added as a consequence of amendments to IFRS 2 *Classification and Measurement of Share-based Payment Transactions* issued in June 2016.

BC377 Consequently the Board decided to amend paragraphs 30–31, and 33 and added paragraphs 33A–33D to clarify the effect that market and non-market vesting conditions and non-vesting conditions have on the measurement of the liability incurred in a cash-settled share-based payment transaction.

BC378 The Board observed that if an employee does not receive the payment because of a failure to satisfy any condition, this should result in remeasuring the liability to zero. The amendments make clear that the cumulative amount ultimately recognised for goods or services received as consideration for a cash-settled share-based payment will be equal to the amount of cash (or other assets) that is paid.

BC379 Furthermore, the Board amended paragraph IG19 and added IG Example 12A to the Guidance on Implementing IFRS 2 to illustrate the impact of a performance condition on the measurement of a cash-settled share-based payment transaction.

BC380 Respondents to the November 2014 ED questioned the meaning of ‘best available estimate’, as that notion was used in the proposal, for estimating the fair value of a cash-settled share-based payment. The Board noted that the term ‘best available estimate’ is already used in IFRS 2 and is not a new notion. This term is also used in paragraph 20 of IFRS 2 for estimating the number of equity instruments expected to vest of an equity-settled share-based payment. The Board further observed that analysing such a notion would potentially involve examining similar notions in other Standards and observed that such notions would be better examined as part of a broader project.

BC381 Respondents to the November 2014 ED suggested that the Board should add an explicit requirement for the disclosure of a contingent liability when vesting is not probable (and thus no liability is recognised, as illustrated in Year 1 of Example 12A). The Board observed that adding such a requirement is not necessary because the general requirement in paragraph 50 of IFRS 2 already requires entities to

...disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity’s profit or loss for the period and on its financial position.

BC382 Some respondents to the November 2014 ED suggested that the Board should add other examples to the Guidance on Implementing IFRS 2 to illustrate the effects of vesting and non-vesting conditions on the measurement of cash-settled awards. The Board did not think this was necessary because of the existing examples in the implementation guidance that illustrate the effects of market and non-market vesting conditions and of non-vesting conditions on equity-settled awards. These examples also serve to illustrate the effects of such conditions on cash-settled awards because the amendments require consistent treatment for both types of awards.

*Guidance on Implementing
Hong Kong Financial Reporting Standard 2*

Share-based Payment



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Cash-settled share-based payment transactions

- IG18 Paragraphs 30–33 of the IFRS set out requirements for transactions in which an entity acquires goods or services by incurring liabilities to the supplier of those goods or services in amounts based on the price of the entity's shares or other equity instruments. The entity is required to recognise initially the goods or services acquired, and a liability to pay for those goods or services, when the entity obtains the goods or as the services are rendered, measured at the fair value of the liability. Thereafter, until the liability is settled, the entity is required to recognise changes in the fair value of the liability.
- IG19 For example, an entity might grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time. If the share appreciation rights do not vest until the employees have completed a specified period of service, the entity recognises the services received, and a liability to pay for them, as the employees render service during that period. The liability is measured, initially and at the end of each reporting period until settled, at the fair value of the share appreciation rights, ~~by applying an option pricing model, and the extent to which the employees have rendered service to date,~~ in accordance with paragraphs 30–33D of IFRS 2. Changes in fair value are recognised in profit or loss. Therefore, if the amount recognised for the services received was included in the carrying amount of an asset recognised in the entity's statement of financial position (e.g. for example, inventory), the carrying amount of that asset is not adjusted for the effects of the liability remeasurement. Example 12 illustrates these requirements for a cash-settled share-based payment transaction that is subject to a service condition. Example 12A illustrates these requirements for a cash-settled share-based payment transaction that is subject to a performance condition.

... continued
IG Example 12

4	(253 – 140) employees × 100 SARs × CU21.40 – CU460,460	(218,640)	241,820
	+ 140 employees × 100 SARs × CU20.00	<u>280,000</u>	
	Total		61,360
5	CU0 – CU241,820	(241,820)	0
	+ 113 employees × 100 SARs × CU25.00	<u>282,500</u>	
	Total		<u>40,680</u>
	Total		<u><u>787,500</u></u>

IG Example 12A

Background

An entity grants 100 cash-settled share appreciation rights (SARs) to each of its 500 employees on the condition that the employees remain in its employ for the next three years and the entity reaches a revenue target (CU1 billion in sales) by the end of Year 3. The entity expects all employees to remain in its employ.

For simplicity, this example assumes that none of the employees' compensation qualifies for capitalisation as part of the cost of an asset.

At the end of Year 1, the entity expects that the revenue target will not be achieved by the end of Year 3. During Year 2, the entity's revenue increased significantly and it expects that it will continue to grow. Consequently, at the end of Year 2, the entity expects that the revenue target will be achieved by the end of Year 3.

At the end of Year 3, the revenue target is achieved and 150 employees exercise their SARs. Another 150 employees exercise their SARs at the end of Year 4 and the remaining 200 employees exercise their SARs at the end of Year 5.

Using an option pricing model, the entity estimates the fair value of the SARs, ignoring the revenue target performance condition and the employment-service condition, at the end of each year until all of the cash-settled share-based payments are settled. At the end of Year 3, all of the SARs vest. The following table shows the estimated fair value of the SARs at the end of each year and the intrinsic values of the SARs at the date of exercise (which equals the cash paid out).

continued...

...continued
IG Example 12A

		Fair value of one SAR	Intrinsic value of one SAR
<u>Year</u>			
<u>1</u>		CU14.40	=
<u>2</u>		CU15.50	=
<u>3</u>		CU18.20	CU15.00
<u>4</u>		CU21.40	CU20.00
<u>5</u>		CU25.00	CU25.00
<u>Application of requirements</u>		Number of employees expected to satisfy the service condition	Best estimate of whether the revenue target will be met
<u>Year 1</u>		500	No
<u>Year 2</u>		500	Yes
<u>Year 3</u>		500	Yes
<u>Year</u>	<u>Calculation</u>	<u>Expense</u> <u>CU</u>	<u>Liability</u> <u>CU</u>
<u>1</u>	<u>SARs are not expected to vest: no expense is recognised</u>	=	=
<u>2</u>	<u>SARs are expected to vest: 500 employees × 100 SARs × CU15.50 × 2/3</u>	516,667	516,667
<u>3</u>	<u>(500–150) employees × 100 SARs × CU18.20 x 3/3–CU516,667</u> <u>+ 150 employees × 100 SARs × CU15.00</u>	120,333 <u>225,000</u>	637,000
	<u>Total</u>	345,333	
<u>4</u>	<u>(350–150) employees × 100 SARs × CU21.40–CU637,000</u> <u>+ 150 employees × 100 SARs × CU20.00</u>	(209,000) <u>300,000</u>	428,000
	<u>Total</u>	91,000	
<u>5</u>	<u>(200–200) employees × 100 SARs × CU25.00–CU428,000</u>	(428,000)	=
<u>continued...</u>			

...continued
IG Example 12A

	+ 200 employees × 100 SARs × CU25.00	<u>500,000</u>
Total		<u>72,000</u>
Total		<u>1,025,000</u>

Share-based payment transactions with a net settlement feature for withholding tax obligations

IG19A Paragraphs 33E and 33F require an entity to classify an arrangement in its entirety as an equity-settled share-based payment transaction if it would have been so classified in the absence of a net settlement feature that obliges the entity to withhold an amount for an employee's tax obligation associated with a share-based payment. The entity transfers that amount, normally in cash, to the tax authority on the employee's behalf. Example 12B illustrates these requirements.

IG Example 12B

Background

The tax law in jurisdiction X requires entities to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount in cash to the tax authority on the employee's behalf.

On 1 January 20X1 an entity in jurisdiction X grants an award of 100 shares to an employee; that award is conditional upon the completion of four years' service. The entity expects that the employee will complete the service period. For simplicity, this example assumes that none of the employee's compensation qualifies for capitalisation as part of the cost of an asset.

The terms and conditions of the share-based payment arrangement require the entity to withhold shares from the settlement of the award to its employee in order to settle the employee's tax obligation (that is, the share-based payment arrangement has a 'net settlement feature'). Accordingly, the entity settles the transaction on a net basis by withholding the number of shares with a fair value equal to the monetary value of the employee's tax obligation and issuing the remaining shares to the employee on completion of the vesting period.

The employee's tax obligation associated with the award is calculated based on the fair value of the shares on the vesting date. The employee's applicable tax rate is 40 per cent.

At grant date, the fair value of each share is CU2. The fair value of each share at 31 December 20X4 is CU10.

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...continued
IG Example 12B

The fair value of the shares on the vesting date is CU1,000 (100 shares × CU10 per share) and therefore the employee's tax obligation is CU400 (100 shares × CU10 × 40%). Accordingly, on the vesting date, the entity issues 60 shares to the employee and withholds 40 shares (CU400 = 40 shares × CU10 per share). The entity pays the fair value of the withheld shares in cash to the tax authority on the employee's behalf. In other words, it is as if the entity had issued all 100 vested shares to the employee, and at the same time, repurchased 40 shares at their fair value.

Application of requirements

<u>Year</u>	<u>Calculation</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Cr.</u>
		<u>Expense</u>	<u>Equity</u>	<u>Liability</u>
		<u>CU</u>	<u>CU</u>	<u>CU</u>
<u>1</u>	<u>100 shares × CU2 × 1/4</u>	<u>50</u>	<u>(50)</u>	<u>=</u>
<u>2</u>	<u>100 shares × CU2 × 2/4 – CU50</u>	<u>50</u>	<u>(50)</u>	<u>=</u>
<u>3</u>	<u>100 shares × CU2 × 3/4 – (CU50 + CU50)</u>	<u>50</u>	<u>(50)</u>	<u>=</u>
<u>4</u>	<u>100 shares × CU2 × 4/4 – (CU50 + CU50 + CU50)</u>	<u>50</u>	<u>(50)</u>	<u>=</u>
	<u>Total</u>	<u>200</u>	<u>(200)</u>	<u>=</u>

The journal entries recorded by the entity are as follows:

During the vesting period

Accumulated compensation expense recognised over the vesting period

<u>Dr Expense</u>	<u>200</u>
	<u>Cr Equity</u> <u>200</u>

Recognition of the tax liability^(a)

<u>Dr Equity</u>	<u>400</u>
	<u>Cr Liability</u> <u>400</u>

Settlement of tax obligation

Cash paid to the tax authority on the employee's behalf at the date of settlement

<u>Dr Liability</u>	<u>400</u>
	<u>Cr Cash</u> <u>400</u>

(a) The entity considers disclosing an estimate of the amount that it expects to transfer to the tax authority at the end of each reporting period. The entity makes such disclosure when it determines that this information is necessary to inform users about the future cash flow effects associated with the share-based payment.

Accounting for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled

IG19B The following example illustrates the application of the requirements in paragraphs B44A of IFRS 2 to a modification of the terms and conditions of a cash-settled share-based payment transaction that becomes an equity-settled share-based payment transaction.

IG Example 12C

Background

On 1 January 20X1 an entity grants 100 share appreciation rights (SARs) that will be settled in cash to each of 100 employees on the condition that employees will remain employed for the next four years.

On 31 December 20X1 the entity estimates that the fair value of each SAR is CU10 and consequently, the total fair value of the cash-settled award is CU100,000. On 31 December 20X2 the estimated fair value of each SAR is CU12 and consequently, the total fair value of the cash-settled award is CU120,000.

On 31 December 20X2 the entity cancels the SARs and, in their place, grants 100 share options to each employee on the condition that each employee remains in its employ for the next two years. Therefore the original vesting period is not changed. On this date the fair value of each share option is CU13.20 and consequently, the total fair value of the new grant is CU132,000. All of the employees are expected to and ultimately do provide the required service.

For simplicity, this example assumes that none of the employees' compensation qualifies for capitalisation as part of the cost of an asset.

Application of requirements

At the modification date (31 December 20X2), the entity applies paragraph B44A. Accordingly:

- (a) from the date of the modification, the share options are measured by reference to their modification-date fair value and, at the modification date, the share options are recognised in equity to the extent to which the employees have rendered services;
- (b) the liability for the SARs is derecognised at the modification date; and
- (c) the difference between the carrying amount of the liability derecognised and the equity amount recognised at the modification date is recognised immediately in profit or loss.

At the modification date (31 December 20X2), the entity compares the fair value of the equity-settled replacement award for services provided through to the modification date ($\text{CU}132,000 \times 2/4 = \text{CU}66,000$) with the fair value of the cash-settled original award for those services ($\text{CU}120,000 \times 2/4 = \text{CU}60,000$). The difference (CU6,000) is recognised immediately in profit or loss at the date of the modification.

The remainder of the equity-settled share-based payment (measured at its modification-date fair value) is recognised in profit or loss over the remaining two-year vesting period from the date of the modification.

continued...

...continued
IG Example 12C

<u>Year</u>	<u>Calculation</u>	<u>Dr. Expense CU</u>	<u>Cumulative expense CU</u>	<u>Cr. Equity CU</u>	<u>Cr. Liability CU</u>
<u>1</u>	<u>100 employees × 100 SARs</u> <u>× CU10 × 1/4</u>	<u>25,000</u>	=	=	<u>25,000</u>
<u>2</u>	<u>Remeasurement before the</u> <u>modification 100</u> <u>employees × 100 SARs ×</u> <u>CU12.00 × 2/4–25,000</u>	<u>35,000</u>	<u>60,000</u>	=	<u>35,000</u>
	<u>Derecognition of the</u> <u>liability, recognition of the</u> <u>modification-date fair</u> <u>value amount in equity and</u> <u>recognition of the effect of</u> <u>settlement for CU6,000</u> <u>(100 employees × 100</u> <u>share options × CU13.20 ×</u> <u>2/4)–(100 employees × 100</u> <u>SARs × CU12.00 × 2/4)</u>	<u>6,000</u>	<u>66,000</u>	<u>66,000</u>	<u>(60,000)</u>
<u>3</u>	<u>100 employees × 100 share</u> <u>options × CU13.20 ×</u> <u>3/4–CU66,000</u>	<u>33,000</u>	<u>99,000</u>	<u>33,000</u>	=
<u>4</u>	<u>100 employees × 100 share</u> <u>options × CU13.20 ×</u> <u>4/4–CU99,000</u>	<u>33,000</u>	<u>132,000</u>	<u>33,000</u>	=
	<u>Total</u>			<u>132,000</u>	=

Share-based payment arrangements with cash alternatives

- IG20 Some employee share-based payment arrangements permit the employee to choose whether to receive cash or equity instruments. In this situation, a compound financial instrument has been granted, i.e. a financial instrument with debt and equity components. Paragraph 37 of the IFRS requires the entity to estimate the fair value of the compound financial instrument at grant date, by first measuring the fair value of the debt component, and then measuring the fair value of the equity component—taking into account that the employee must forfeit the right to receive cash to receive the equity instrument.
- IG21 Typically, share-based payment arrangements with cash alternatives are structured so that the fair value of one settlement alternative is the same as the other. For example, the employee might have the choice of receiving share options or cash share appreciation rights. In such cases, the fair value of the equity component will be zero, and hence the fair value of the compound financial instrument will be the same as the fair value of the debt component. However, if the fair values of the settlement alternatives differ, usually the fair value of the equity component will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component.
- IG22 Paragraph 38 of the IFRS requires the entity to account separately for the services received in respect of each component of the compound financial instrument. For the debt component, the entity recognises the services received, and a liability to pay for those services, as the counterparty renders service, in accordance with the requirements applying to cash-settled share-based payment transactions. For the equity component (if any), the entity recognises the services received, and an increase in equity, as the counterparty renders service, in accordance with the requirements applying to equity-settled share-based payment transactions. Example 13 illustrates these requirements.

HKFRS 3 (Revised)
Revised September 2018~~November 2016~~

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations



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- 13 The acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

- 14 Paragraphs B28–B40 provide guidance on recognising operating leases and intangible assets. Paragraphs 22–28 specify the types of identifiable assets and liabilities that include items for which this HKFRS provides limited exceptions to the recognition principle and conditions.

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination

- 15 **At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other HKFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.**

- 16 In some situations, HKFRSs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:

- (a) classification of particular financial assets and liabilities as measured a financial asset or liability at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with HKFRS 9 Financial Instruments available for sale or held to maturity, in accordance with HKAS 39 Financial Instruments: Recognition and Measurement;
- (b) designation of a derivative instrument as a hedging instrument in accordance with HKFRS 9~~HKAS 39~~; and
- (c) assessment of whether an embedded derivative should be separated from ~~the a~~ host contract in accordance with HKFRS 9~~HKAS 39~~ (which is a matter of 'classification' as this HKFRS uses that term).

- 17 This HKFRS provides two exceptions to the principle in paragraph 15:

- (a) classification of a lease contract as either an operating lease or a finance lease in accordance with HKAS 17 *Leases*; and
- (b) classification of a contract as an insurance contract in accordance with HKFRS 4 *Insurance Contracts*.

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

Measurement principle

- 18 **The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.**

- 19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitles their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

- (a) fair value; or

- 42 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income ~~(for example, because the investment was classified as available for sale)~~. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

A business combination achieved without the transfer of consideration

- 43 An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include:
- (a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.
 - (b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.
 - (c) The 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.
- 44 In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree the amount of the acquiree's net assets recognised in accordance with this HKFRS. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

Measurement period

- 45 **If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date. During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.**
- 46 The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this HKFRS:
- (a) the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;

- 52 A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:
- (a) a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
 - (b) a transaction that remunerates employees or former owners of the acquiree for future services; and
 - (c) a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

Paragraphs B50-B62 provide related application guidance.

Acquisition-related costs

- 53 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with HKAS 32 and HKFRS 9~~HKAS 39~~.

Subsequent measurement and accounting

- 54 In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable HKFRSs for those items, depending on their nature. However, this HKFRS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:
- (a) reacquired rights;
 - (b) contingent liabilities recognised as of the acquisition date;
 - (c) indemnification assets; and
 - (d) contingent consideration.

Paragraph B63 provides related application guidance.

Reacquired rights

- 55 A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

Contingent liabilities

- 56 After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

- (a) the amount that would be recognised in accordance with HKAS 37; and
- (b) the amount initially recognised less, if appropriate, the cumulative amortisation amount of income recognised in accordance with ~~HKAS 18 Revenue~~ the principles of HKFRS 15 Revenue from Contracts with Customers.

This requirement does not apply to contracts accounted for in accordance with HKFRS 9 ~~HKAS 39~~.

Indemnification assets

- 57 At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset. The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

Contingent consideration

- 58 Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45-49. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- (a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.
- (b) Other contingent consideration that:
 - (i) is within the scope of HKFRS 9 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with HKFRS 9.
 - (ii) is not within the scope of HKFRS 9 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss.

Disclosures

- 59 The acquirer shall disclose information that enables users of its financial statements to evaluate 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 authorised for issue.

- 60 To meet the objective in paragraph 59, the acquirer shall disclose the information specified in paragraphs B64-B66.
- 61 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.**
- 62 To meet the objective in paragraph 61, the acquirer shall disclose the information specified in paragraph B67.
- 63 If the specific disclosures required by this and other HKFRSs do not meet the objectives set out in paragraphs 59 and 61, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

Effective date and transition

Effective date

- 64 This HKFRS shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. Earlier application is permitted. However, this HKFRS shall be applied only at the beginning of an annual reporting period that begins on or after 30 June 2007. If an entity applies this HKFRS before 1 July 2009, it shall disclose that fact and apply HKAS 27 (as amended in 2008) at the same time.
- 64A ~~[Deleted]~~~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 64B *Improvements to HKFRSs* issued in May 2010 amended paragraphs 19, 30 and B56 and added paragraphs B62A and B62B. An entity shall apply those amendments for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective from the date when the entity first applied this HKFRS.
- 64C Paragraphs 65A–65E were added by *Improvements to HKFRSs* issued in May 2010. An entity shall apply those amendments for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. The amendments shall be applied to contingent consideration balances arising from business combinations with an acquisition date prior to the application of this HKFRS, as issued in 2008.
- 64D ~~[Deleted]~~~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 64E HKFRS 10, issued in June 2011, amended paragraphs 7, B13, B63(e) and Appendix A. An entity shall apply those amendments when it applies HKFRS 10.
- 64F HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended paragraphs 20, 29, 33, 47, amended the definition of fair value in Appendix A and amended paragraphs B22, B40, B43–B46, B49 and B64. An entity shall apply those amendments when it applies HKFRS 13.
- 64G *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraph 7 and added paragraph 2A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies these amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.

- 64H [Deleted]
- 64I *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 40 and 58 and added paragraph 67A and its related heading. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after 1 July 2014. Earlier application is permitted. An entity may apply the amendment earlier provided that HKFRS 9 and HKAS 37 (both as amended by *Annual Improvements to HKFRSs 2010–2012 Cycle*) have also been applied. If an entity applies that amendment earlier it shall disclose that fact.
- 64J *Annual Improvements Cycle 2011–2013* issued in January 2014 amended paragraph 2(a). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- 64K HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 56. An entity shall apply that amendment when it applies HKFRS 15.
- 64L HKFRS 9, as issued in September 2014, amended paragraphs 16, 42, 53, 56 and B41 and deleted paragraphs 64A and 64D. An entity shall apply those amendments when it applies HKFRS 9.

Transition

- 65 Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this HKFRS shall not be adjusted upon application of this HKFRS.
- 65A Contingent consideration balances arising from business combinations whose acquisition dates preceded the date when an entity first applied this HKFRS as issued in 2008 shall not be adjusted upon first application of this HKFRS. Paragraphs 65B–65E shall be applied in the subsequent accounting for those balances. Paragraphs 65B–65E shall not apply to the accounting for contingent consideration balances arising from business combinations with acquisition dates on or after the date when the entity first applied this HKFRS as issued in 2008. In paragraphs 65B–65E business combination refers exclusively to business combinations whose acquisition date preceded the application of this HKFRS as issued in 2008.
- 65B If a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably.
- 65C A business combination agreement may allow for adjustments to the cost of the combination that are contingent on one or more future events. The adjustment might, for example, be contingent on a specified level of profit being maintained or achieved in future periods, or on the market price of the instruments issued being maintained. It is usually possible to estimate the amount of any such adjustment at the time of initially accounting for the combination without impairing the reliability of the information, even though some uncertainty exists. If the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.
- 65D However, when a business combination agreement provides for such an adjustment, that adjustment is not included in the cost of the combination at the time of initially accounting for the combination if it either is not probable or cannot be measured reliably. If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.

Measuring the fair value of particular identifiable assets and a non-controlling interest in an acquiree (application of paragraphs 18 and 19)

Assets with uncertain cash flows (valuation allowances)

- B41 The acquirer shall not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this HKFRS requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values in accounting for a business combination, the acquirer does not recognise a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date or a loss allowance for expected credit losses.

Assets subject to operating leases in which the acquiree is the lessor

- B42 In measuring the acquisition-date fair value of an asset such as a building or a patent that is subject to an operating lease in which the acquiree is the lessor, the acquirer shall take into account the terms of the lease. In other words, the acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms as paragraph B29 requires for leases in which the acquiree is the lessee.

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

- B43 To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired non-financial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the non-financial asset assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and when measuring fair value less costs of disposal for subsequent impairment testing.

Non-controlling interest in an acquiree

- B44 This HKFRS allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a non-controlling interest on the basis of a quoted price in an active market for the equity shares (ie those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.
- B45 The fair values of the acquirer's interest in the acquiree and the non-controlling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a non-controlling interest discount) in the per-share fair value of the non-controlling interest if market participants would take into account such a premium or discount when pricing the non-controlling interest.

Measuring goodwill or a gain from a bargain purchase

Measuring the acquisition-date fair value of the acquirer's interest in the acquiree using valuation techniques (application of paragraph 33)

- B46 In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see paragraphs 32–34).

Special considerations in applying the acquisition method to combinations of mutual entities (application of paragraph 33)

- B47 When two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, paragraph 33 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred as consideration. In addition, the acquirer in a combination of mutual entities shall recognise the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.
- B48 Although they are similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.
- B49 A fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, a present value technique may be used to measure the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

Determining what is part of the business combination transaction (application of paragraphs 51 and 52)

- B50 The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction is part of the exchange for the acquiree or whether the transaction is separate from the business combination:
- (a) **the reasons for the transaction** – Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers – and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.
 - (b) **who initiated the transaction** – Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners

Basis for Conclusions on
Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

- BC37 Both boards observed that an important part of decision-useful information is information about cash-generating abilities and cash flows generated. The IASB's *Framework^{*} for the Preparation and Presentation of Financial Statements* says that 'The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation' (paragraph 15).[#] FASB Concepts Statement No. 1 *Objectives of Financial Reporting by Business Enterprises* indicates that '... financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise' (paragraph 37; footnote reference omitted). Neither the cash-generating abilities of the combined entity nor its future cash flows generally are affected by the method used to account for the combination. However, fair values reflect the expected cash flows associated with acquired assets and assumed liabilities. Because the pooling method records the net assets acquired at their carrying amounts rather than at their fair values, the information that the pooling method provides about the cash-generating abilities of those net assets is less useful than that provided by the acquisition method.
- BC38 Both boards also concluded that the information provided by the pooling method is less relevant because it has less predictive value and feedback value than the information that is provided by other methods. It is also less complete because it does not reflect assets acquired or liabilities assumed that were not included in the pre-combination financial statements of the combining entities. The pooling method also provides a less faithful representation of the combined entity's performance in periods after the combination. For example, by recording assets and liabilities at the carrying amounts of predecessor entities, post-combination revenues may be overstated (and expenses understated) as the result of embedded gains that were generated by predecessor entities but not recognised by them.
- BC39 The *Framework* and FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information* describe comparability as an important characteristic of decision-useful information. Use of different accounting methods for the same set of facts and circumstances makes the resulting information less comparable and thus less useful for making economic decisions. As discussed in paragraphs BC29–BC35, the boards concluded that all business combinations are economically similar. Accordingly, use of the same method to account for all combinations enhances the comparability of the resulting financial reporting information. Both boards observed that the acquisition method, but not the pooling method, could reasonably be applied to all business combinations in which one party to the combination obtains control over the combined entity.
- BC40 Opponents of the pooling method generally said that eliminating that method would enhance the comparability of financial statements of entities that grow by means of acquisitions. Both boards agreed.

Inconsistent with historical cost accounting model

- BC41 Both boards observed that the pooling method is an exception to the general concept that exchange transactions are accounted for in terms of the fair values of the items exchanged. Because the pooling method records the combination in terms of the pre-combination carrying amounts of the parties to the transaction, it fails to record and thus to hold management accountable for the investment made in the combination.
- BC42 Some respondents to the FASB's 1999 Exposure Draft who advocated use of the pooling method asserted that it is consistent with the historical cost model and that eliminating the pooling method would be a step towards adopting a fair value model. They argued that before eliminating the pooling method, the FASB should resolve the broad issue of whether to adopt a fair value model in place of the historical cost model. The FASB disagreed, noting that, regardless of the merits of a fair value model, the pooling method is an aberration that is inconsistent with the historical cost model.

^{*} In this Basis for Conclusions references to the *Framework* are to IASB's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

[#] superseded by Chapter 1 of the *Conceptual Framework*.

- BC183 The boards rejected the alternative of treating a reacquired right as the termination of a pre-existing relationship because reacquisition of, for example, a franchise right does not terminate the right. After a business combination, the right to operate a franchised outlet in a particular region continues to exist. The difference is that the acquirer, rather than the acquiree by itself, now controls the franchise right.
- BC184 The boards also rejected recognising a reacquired right as part of goodwill. Supporters of that alternative consider that such a right differs from other identifiable intangible assets recognised in a business combination because, from the perspective of the combined entity, a franchising relationship with an outside party no longer exists. As already noted, however, the reacquired right and the related cash flows continue to exist. The boards concluded that recognising that right separately from goodwill provides users of the financial statements of the combined entity with more decision-useful information than subsuming the right into goodwill. The boards also observed that a reacquired right meets the contractual-legal and the separability criteria and therefore qualifies as an identifiable intangible asset.

Classifying and designating assets acquired and liabilities assumed

- BC185 In some situations, IFRSs and US GAAP provide for different accounting depending on how a particular asset or liability is classified or designated. For example, in accordance with both IAS 39 *Financial Instruments: Recognition and Measurement*^{*} and FASB Statement No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, the accounting for particular financial instruments differs depending on how the instrument is classified, for example, as at fair value through profit or loss, available for sale or held to maturity. Another example is the accounting for a derivative instrument in accordance with either IAS 39[#] or FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), which depends on whether the derivative is designated as a hedge, and if so, the type of hedge designated.
- BC186 The 2005 Exposure Draft proposed that the classification of an acquired lease would not change from the acquiree's classification at lease inception unless the terms of the lease were modified as a result of the business combination in a way that would require a different classification in accordance with IAS 17 or SFAS 13. But that exposure draft did not address classification or designation issues pertaining to other types of contracts. Some respondents and others asked the boards to provide additional guidance on when the acquirer in a business combination should reconsider and perhaps change the classification or designation of a contract for the purpose of applying other accounting requirements.
- BC187 The boards decided that providing a general principle for classifying or designating contracts acquired in a business combination would facilitate consistent implementation of the revised standards. They observed that application of the acquisition method results in the initial recognition in the acquirer's financial statements of the assets acquired and liabilities assumed in a business combination. Therefore, in concept, the acquirer should classify and designate all items acquired in a business combination at the acquisition date in the context of the contractual terms, economic conditions and other pertinent factors at that date. That concept underlies the classification and designation principle (paragraph 15 of the revised IFRS 3).
- BC188 In the two situations described in paragraph 17 of the revised IFRS 3, classification of a lease contract as an operating lease or a finance lease and classification of a contract as an insurance or reinsurance contract or a deposit contract, other IFRSs and US GAAP require an entity to classify a contract only at its inception, on the basis of contractual terms and other factors at that date. Because those requirements apply to specific types of contracts regardless of the identity of the parties to the contract, the boards concluded that such requirements should also apply in accounting for a business combination. Thus, the revised standards provide an exception to the principle for classifying and designating assets acquired and liabilities assumed in a business combination for the two types of contracts identified in paragraph 17.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

IFRS 9 *Financial Instruments* replaced the hedge accounting requirements in IAS 39.

BC240 The FASB understands that distinguishing between measurement period adjustments and other changes in the amounts of assets and liabilities arising from contingencies will sometimes be difficult. It observed, however, that similar difficulties exist for other assets acquired and liabilities assumed in a business combination; changes in the amounts of those assets and liabilities after the acquisition date are included in earnings. The FASB saw no compelling reason to treat items arising from contingencies differently.

BC241 Those who favoured reporting subsequent changes in the amounts recognised for assets and liabilities arising from contingencies in other comprehensive income rather than in earnings generally analogised to the present accounting for available-for-sale securities. They said that items arising from contingencies were not 'realised' until the contingency is resolved. The FASB rejected that alternative because it saw no compelling reason to add to the category of items that are initially recognised as other comprehensive income and later 'recycled' to earnings. The FASB considers reporting subsequent changes in the amounts of items arising from contingencies in earnings not only conceptually superior to reporting those changes only in comprehensive income but also consistent with the way in which other changes in amounts of items acquired or assumed in a business combination are recognised.

The IASB's conclusions on initial and subsequent measurement of contingent liabilities

BC242 As noted in paragraph BC223, the IASB's measurement guidance on contingencies carries forward the related guidance in IFRS 3 (except for clarifying that an acquirer cannot recognise a contingency that is not a liability), pending completion of the project to revise IAS 37. Accordingly, contingent liabilities recognised in a business combination are initially measured at their acquisition-date fair values.

BC243 In developing IFRS 3, the IASB observed that not specifying the subsequent accounting for contingent liabilities recognised in a business combination might result in inappropriately derecognising some or all of those contingent liabilities immediately after the combination.

BC244 In ED 3 the IASB proposed that a contingent liability recognised in a business combination should be excluded from the scope of IAS 37 and subsequently measured at fair value with changes in fair value recognised in profit or loss until the liability is settled or the uncertain future event described in the definition of a contingent liability is resolved. In considering respondents' comments on this issue, the IASB noted that subsequently measuring such contingent liabilities at fair value would be inconsistent with the conclusions it reached on the accounting for financial guarantees and commitments to provide loans at below-market interest rates when it revised IAS 39.^α

BC245 The IASB decided to revise the proposal in ED 3 for consistency with IAS 39. Therefore, the revised IFRS 3 requires contingent liabilities recognised in a business combination to be measured after their initial recognition at the higher of:

- (a) the amount that would be recognised in accordance with IAS 37; and
- (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.^β

Definition of fair value *

BC246 The revised IFRS 3 and SFAS 141(R) each use the same definition of fair value that the IASB and the FASB respectively use in their other standards. Specifically, IAS 39^γ and other IFRSs define fair value as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction' and the revised IFRS 3 uses that definition. SFAS 157, on the other hand, defines *fair value* as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' and that definition is used in SFAS 141(R).[#]

^α IFRS 9 *Financial Instruments* relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.

^β IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 56 of IFRS 3 for consistency with the requirements in IFRS 15.

^{*} IFRS 13, issued in May 2011, defines fair value.

^γ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

[#] IFRS 13, issued in May 2011, is the result of the IASB's and the FASB's joint project on fair value measurement. As a result, the definition of fair value in IFRSs is identical to the definition in US GAAP (Topic 820 *Fair Value Measurement* in the FASB Accounting Standards Codification® codified SFAS 157).

BC256 As they did in developing the 2005 Exposure Draft, the boards acknowledged that the requirement to measure receivables and similar assets at fair value with no separate valuation allowance may lead to additional costs for some entities. However, the boards observed that entities that apply IAS 39* are required to measure financial assets acquired outside a business combination, as well as those originated, at fair value on initial recognition. The boards do not think financial or other assets should be measured differently because of the nature of the transaction in which they are acquired. Because the boards saw no compelling reason to provide an exception to the measurement principle for receivables or other assets with credit risk, they affirmed their conclusion that the benefits of measuring receivables and similar assets at fair value justify the related costs.

BC257 Some respondents to the 2005 Exposure Draft said that separate recognition of valuation allowances for loans and similar assets was important to users in evaluating the credit assumptions built into loan valuations. They suggested that the fair value of receivables should be split into three components: (a) the gross contractual amounts, (b) a separate discount or premium for changes in interest rates and (c) a valuation allowance for the credit risk, which would be based on the contractual cash flows expected to be uncollectible. In evaluating that alternative presentation, the boards noted that the valuation allowance presented would differ from the valuation allowance for receivables under IAS 39 and SFAS 5, each of which is determined on the basis of incurred, rather than expected, losses. Thus, how to determine the valuation allowance on an ongoing basis would be problematic. For example, if requirements for other receivables were applied, an immediate gain would be recognised for the difference between incurred losses and expected losses. In contrast, if the valuation allowance for receivables acquired by transfer, including in a business combination, rather than by origination was determined subsequently on an expected loss basis, the result would be a new accounting model for those receivables. The boards concluded that this project is not the place to consider the broader issues of how best to determine the valuation allowances for receivables, regardless of the manner in which the receivables are acquired.

Disclosure of information about receivables acquired

BC258 Some constituents asked the boards to consider requiring additional disclosures about receivables measured at fair value to help in assessing considerations of credit quality included in the fair value measures, including expectations about receivables that will be uncollectible. Those constituents were concerned that, without additional disclosure, it would be impossible to determine the contractual cash flows and the amount of the contractual cash flows not expected to be collected if receivables were recognised at fair value. In response to those comments, the boards decided to require disclosure of the fair value of receivables acquired, the gross contractual amounts receivable and the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures are required for each major class of receivable.

BC259 In January 2007 the FASB added a project to its technical agenda to improve disclosures relating to the allowance for credit losses associated with financing receivables. As part of that project, the FASB is considering potential new disclosures and enhanced current disclosures about the credit quality of an entity's portfolio, the entity's credit risk exposures, its accounting policies on valuation allowances and possibly other areas.

BC260 The boards observed that the work involved in developing a complete set of credit quality disclosures to be made for receivables acquired in a business combination would be similar to that required in the FASB's disclosure project related to valuation allowances. Combining those efforts would be a more efficient use of resources. Accordingly, the FASB decided to include disclosures that should be made in a business combination in the scope of its project on disclosures related to valuation allowances and credit quality, and the IASB will monitor that project. In the interim, the disclosures required by the revised standards (paragraph B64(h) of the revised IFRS 3) will provide at least some, although perhaps not all, of the information users need to evaluate the credit quality of receivables acquired.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

- BC261 While the revised standards were being developed, the FASB received enquiries about inconsistencies in practice in accordance with SFAS 141 related to measuring particular intangible assets that an acquirer intends not to use or intends to use in a way different from the way other market participants would use them. For example, if the acquirer did not intend to use a brand name acquired in a business combination, some entities assigned no value to the asset and other entities measured it at the amount at which market participants could be expected to exchange the asset, ie at its fair value.
- BC262 To avoid such inconsistencies in practice, the boards decided to clarify the measurement of assets that an acquirer intends not to use (paragraph B43 of the revised IFRS 3). The intention of both IFRS 3 and SFAS 141 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them. The FASB observed that measuring such assets in accordance with their highest and best use is consistent with SFAS 157. Paragraph A12 of SFAS 157 illustrates determining the fair value of an in-process research and development project acquired in a business combination that the acquirer does not intend to complete. The IASB understands from its consultation with preparers, valuation experts and auditors that IFRS 3 was applied in the way the revised standards require.*

Exceptions to the recognition or measurement principle

- BC263 As indicated in paragraphs 14 and 20 of the revised IFRS 3, the revised standards include limited exceptions to ~~the~~^{its} recognition and measurement principles. Paragraphs BC265–BC311 discuss the types of identifiable assets and liabilities for which exceptions are provided and the reasons for those exceptions.
- BC264 It is important to note that not every item that falls into a particular type of asset or liability is an exception to either the recognition or the measurement principle (or both). For example, contingent liabilities are identified as an exception to the recognition principle because the revised IFRS 3 includes a recognition condition for them in addition to the recognition conditions in paragraphs 11 and 12. Although applying that additional condition will result in not recognising some contingent liabilities, those that meet the additional condition will be recognised in accordance with the recognition principle. Another example is employee benefits, which are identified as a type of asset or liability for which exceptions to both the recognition and the measurement principles are provided. As discussed further in paragraphs BC296–BC300, the acquirer is required to recognise and measure liabilities and any related assets resulting from the acquiree's employee benefit arrangements in accordance with IAS 19 *Employee Benefits* rather than by applying the recognition and measurement principles in the revised IFRS 3. Applying the requirements of IAS 19 will result in recognising many, if not most, types of employee benefit liabilities in the same way as would result from applying the recognition principle (see paragraph BC297). However, others, for example withdrawal liabilities from multi-employer plans for entities applying US GAAP, are not necessarily consistent with the recognition principle. In addition, applying the requirements of IAS 19 generally will result in measuring liabilities for employee benefits (and any related assets) on a basis other than their acquisition-date fair values. However, applying the requirements of SFAS 146 to one-off termination benefits results in measuring liabilities for those benefits at their acquisition-date fair values.

Exception to the recognition principle

Assets and liabilities arising from contingencies

- BC265 Both the FASB's conclusions on recognising assets and liabilities arising from contingencies and the IASB's conclusions on recognising contingent liabilities resulted in exceptions to the recognition principle in the revised standards because both will result in some items being unrecognised at the acquisition date. However, the details of the

* IFRS 13, issued in May 2011, describes the concept of highest and best use and provides examples of its application in a business combination.

BC331 Because business combinations are generally exchange transactions in which knowledgeable, unrelated willing parties exchange equal values, the boards continue to believe that the acquisition-date fair value of the consideration transferred provides the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree in many, if not most, situations. However, that is not the case if the acquirer either makes a bargain purchase or pays more than the acquiree is worth at the acquisition date—if the acquirer underpays or overpays. The revised standards provide for recognising a gain in the event of a bargain purchase, but they do not provide for recognising a loss in the event of an overpayment (paragraph BC382). Therefore, the boards concluded that focusing directly on the fair value of the consideration transferred rather than on the fair value of the acquirer's interest in the acquiree, with a presumption that the two amounts are usually equal, would be a more straightforward way of describing how to measure goodwill. (The same conclusion applies to measuring the gain on a bargain purchase, which is discussed in paragraphs BC371–BC381.) That change in focus will also avoid unproductive disputes in practice about whether the consideration transferred or another valuation technique provides the best evidence for measuring the acquirer's interest in the acquiree in a particular situation.

Using the acquirer's interest in the acquiree to measure goodwill

BC332 The boards acknowledge that in the absence of measurable consideration, the acquirer is likely to incur costs to measure the acquisition-date fair value of its interest in the acquiree and incremental costs to have that measure independently verified. The boards observed that in many of those circumstances companies already incur such costs as part of their due diligence procedures. For example, an acquisition of a privately held entity by another privately held entity is often accomplished by an exchange of equity shares that do not have observable market prices. To determine the exchange ratio, those entities generally engage advisers and valuation experts to assist them in valuing the acquiree as well as the equity transferred by the acquirer in exchange for the acquiree. Similarly, a combination of two mutual entities is often accomplished by an exchange of member interests of the acquirer for all of the member interests of the acquiree. In many, but not necessarily all, of those cases the directors and managers of the entities also assess the relative fair values of the combining entities to ensure that the exchange of member interests is equitable to the members of both entities.

BC333 The boards concluded that the benefits in terms of improved financial information resulting from the revised standards outweigh the incremental measurement costs that the revised standards may require. Those improvements include the increased relevance and understandability of information resulting from applying the revised standards' measurement principle and guidance on recognising and measuring goodwill, which are consistent with reflecting the change in economic circumstances that occurs at that date.

BC334 The 2005 Exposure Draft included illustrative guidance for applying the fair value measurement requirement if no consideration is transferred or the consideration transferred is not the best evidence of the acquisition-date fair value of the acquiree. That illustrative guidance drew on related guidance in the FASB's exposure draft that preceded SFAS 157. Because SFAS 157 provides guidance on using valuation techniques such as the market approach and the income approach for measuring fair value, the FASB decided that it is unnecessary for SFAS 141(R) to provide the same guidance.

BC335 The IASB decided not to include in the revised IFRS 3 guidance on using valuation techniques to measure the acquisition-date fair value of the acquirer's interest in the acquiree. The IASB has on its agenda a project to develop guidance on measuring fair value. While deliberations on that project are in progress, the IASB considers it inappropriate to include fair value measurement guidance in IFRSs.

BC336 The FASB, on the other hand, completed its project on fair value measurement when it issued SFAS 157. SFAS 141(R), together with SFAS 157, provides broadly applicable measurement guidance that is relevant and useful in measuring the acquirer's interest in the acquiree. However, both boards were concerned that without some discussion of

- BC351 The boards concluded that the requirements for awards of share-based payment subject to performance conditions should not determine the requirements for contingent (or conditional) consideration in a business combination. In addition, the boards concluded that the negotiations between buyer and seller inherent in a contingent consideration arrangement in a business combination provide better evidence of its fair value than is likely to be available for most share-based payment arrangements with performance conditions.
- BC352 The boards also noted that some contingent consideration arrangements oblige the acquirer to deliver its equity securities if specified future events occur. The boards concluded that the classification of such instruments as either equity or a liability should be based on existing IFRSs or US GAAP, as indicated in paragraph 40 of the revised IFRS 3.

Subsequent measurement of contingent consideration

- BC353 For reasons similar to those discussed in the context of contingent liabilities (paragraphs BC232 and BC243), the boards concluded that the revised standards must address subsequent accounting for contingent consideration. For consistency with the accounting for other obligations that require an entity to deliver its equity shares, the boards concluded that obligations for contingent payments that are classified as equity should not be remeasured after the acquisition date.
- BC354 The boards observed that many obligations for contingent consideration that qualify for classification as liabilities meet the definition of derivative instruments in IAS 39^{*} or SFAS 133. To improve transparency in reporting particular instruments, the boards concluded that all contracts that would otherwise be within the scope of those standards (if not issued in a business combination) should be subject to their requirements if issued in a business combination. Therefore, the boards decided to eliminate their respective provisions (paragraph 2(f) of IAS 39 and paragraph 11(c) of SFAS 133) that excluded contingent consideration in a business combination from the scope of those standards. Accordingly, liabilities for payments of contingent consideration that are subject to the requirements of IAS 39 or SFAS 133 would subsequently be measured at fair value at the end of each reporting period, with changes in fair value recognised in accordance with whichever of those standards an entity applies in its financial statements.
- BC355 In considering the subsequent accounting for contingent payments that are liabilities but are not derivatives, the boards concluded that, in concept, all liabilities for contingent payments should be accounted for similarly. Therefore, liabilities for contingent payments that are not derivative instruments should also be remeasured at fair value after the acquisition date. The boards concluded that applying those provisions would faithfully represent the fair value of the liability for the contingent payment of consideration that remains a liability until settled.
- BC356 The boards also considered whether subsequent changes in the fair values of liabilities for contingent consideration should be reflected as adjustments to the consideration transferred in the business combination (usually in goodwill). Some respondents to the 2005 Exposure Draft favoured that alternative because they thought that changes in the fair value of contingent consideration effectively resolve differing views of the acquirer and the former owners of the acquiree about the acquisition-date fair value of the acquiree. The boards acknowledged that a conclusive determination at the acquisition date of the fair value of a liability for contingent consideration might not be practicable in the limited circumstances in which particular information is not available at that date. As discussed in more detail in paragraphs BC390–BC400, the boards decided that the revised standards should provide for provisional measurement of the fair value of assets acquired or liabilities assumed or incurred, including liabilities for contingent payments, in those circumstances.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Clarification on the accounting for contingent consideration in a business combination

- BC360A The IASB clarified the accounting for contingent consideration arising from business combinations.

Classification of contingent consideration in a business combination

- BC360B The IASB noted that the classification requirements in paragraph 40 of IFRS 3 were unclear as to when, if ever, “other applicable IFRSs” would need to be used to determine the classification of contingent consideration as a financial liability or as an equity instrument. Consequently, the IASB deleted the reference to “other applicable IFRSs” in paragraph 40.

Subsequent measurement of contingent consideration in a business combination

- BC360C The IASB also noted that the requirements for subsequent measurement in paragraph 58 require contingent consideration, other than that which meets the definition of equity in accordance with IAS 32 *Financial Instruments: Presentation*, to be subsequently measured at fair value. However, paragraph 58 then refers to IFRS 9 *Financial Instruments* (or IAS 39, if IFRS 9 has not yet been applied), IAS 37 or other IFRSs as appropriate, which may not require subsequent measurement at fair value.

Subsequent measurement of contingent consideration that is a financial instrument

- BC360D The IASB noted that the requirements for subsequent measurement in paragraph 58 for contingent consideration that is a financial instrument within the scope of IFRS 9 (or IAS 39*) were inconsistent with the accounting requirements of IFRS 9 (or IAS 39). Because paragraph 58 referred to IFRS 9 (or IAS 39), which allows amortised cost measurement in some circumstances, contingent consideration that is a financial liability might be classified as being measured at amortised cost. This would conflict with the requirement in paragraph 58 that such contingent consideration should be subsequently measured at fair value. Consequently, the IASB amended the classification requirements of IFRS 9 (and IAS 39) to ensure that the subsequent measurement requirement for contingent consideration that is a financial liability is fair value. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.
- BC360E In redeliberating this issue, the IASB decided that it would not be possible for contingent consideration that is a financial asset that meets the requirements in IFRS 9 to be subsequently measured at amortised cost (because the contractual terms of contingent consideration that is a financial asset would not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding). Consequently, the IASB decided that the proposed amendments to paragraph 4.1.2 of IFRS 9 in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* were not needed.
- BC360F The IASB also decided that changes in fair value of any contingent consideration that is a financial asset or a financial liability should be recognised in profit or loss. Consequently, the IASB decided to amend paragraph 5.7.5 of IFRS 9 to ensure that any change in the fair value of investments in equity instruments that are contingent consideration in a business combination should be presented in profit or loss. The IASB noted that it was unlikely that contingent consideration that is an asset would meet the definition of equity. However, it decided to amend the paragraph to ensure that all contingent consideration that is made up of financial instruments is accounted for consistently.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Subsequent measurement of contingent consideration that is a non-financial asset or a non-financial liability

BC360G The IASB also noted that the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is a non-financial asset or a non-financial liability may conflict with the measurement requirements in other applicable Standards. The conflict arises because paragraph 58 refers to changes in the fair value of contingent consideration but paragraph 58(b) refers to Standards that do not require fair value as a measurement basis, for example, IAS 37. Consequently, the IASB deleted the reference to “IAS 37 or other IFRSs as appropriate” from paragraph 58(b). This, therefore, maintains fair value as the subsequent measurement basis for all non equity contingent consideration to which IFRS 3 applies. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

BC360H The IASB also decided that the full change in the fair value of any contingent consideration that is a non-financial asset or a non-financial liability should be recognised in profit or loss.

Other considerations given to subsequent measurement of contingent consideration

BC360I The IASB considered alternatives for the subsequent measurement requirements for contingent consideration. It considered whether all references to other Standards, including references to IFRS 9 (or IAS 39^{*}), should be removed and instead all necessary guidance for the subsequent measurement of contingent consideration should be included in IFRS 3. It decided, however, to amend IFRS 9 (and IAS 39) as a consequential amendment derived from the amendment to IFRS 3 and to retain the link to IFRS 9 (or IAS 39) so that the general guidance in IFRS 9 (or IAS 39) applies to contingent consideration that is within the scope of IFRS 9 (or IAS 39). The IASB also considered whether some liability contingent consideration should be measured at fair value with some fair value changes being presented in other comprehensive income. It decided that it was preferable that the guidance was consistent for all liability contingent consideration and, consequently, it decided that all liability contingent consideration should be subsequently measured at fair value with any resulting gain or loss, including gain or loss attributable to changes in own credit risk, being recognised in profit or loss.

Disclosure

BC360J Some stakeholders had asked whether the IASB had intended the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* to apply to contingent consideration, noting that there are disclosure requirements for contingent consideration in IFRS 3. The IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7. Consequently, the IASB decided not to make any changes to the scope of IFRS 7 to exclude such financial instruments.

Replacement awards

BC361 An acquirer sometimes issues replacement awards to benefit the employees of the acquiree for past services, for future services or for both. Accordingly, the 2005 Exposure Draft included guidance for determining the extent to which replacement awards are for past services (and thus part of the consideration transferred in the business combination) or future services (and thus not part of the consideration transferred). In developing that guidance, the boards’ objective was, as far as possible, to be consistent with the guidance in their respective standards on share-based payments.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC388 Some respondents who agreed that an acquirer should remeasure its previously held equity interest at fair value would recognise any resulting gain or loss in other comprehensive income rather than in profit or loss. Those respondents said that the accounting for previously held equity interests is similar to the accounting for available-for-sale securities. Changes in the value of available-for-sale securities are recognised in other comprehensive income. They view each step in a step acquisition as a transaction in which the acquirer only obtains more shares in the acquiree. Because the shares that the acquirer previously held have not been exchanged or sold, they think that the recognition of profit or loss is not appropriate.
- BC389 The boards understand that the required treatment of a previously held equity investment in a step acquisition is different from the initial recognition of gains or losses on available-for-sale securities*. However, the boards noted that changes in the value of available-for-sale securities are recognised in profit or loss when the securities are derecognised. In a business combination achieved in stages, the acquirer derecognises its investment asset in an entity in its consolidated financial statements when it achieves control. Thus, the boards concluded that it is appropriate to recognise any resulting gain or loss in profit or loss at the acquisition date.

Measurement period

- BC390 The revised standards provide an acquirer with a reasonable period after the acquisition date, a *measurement period*, during which to obtain the information necessary to identify and measure the items specified in paragraph 46 of the revised IFRS 3 as of the acquisition date in accordance with the requirements of the revised standards. If sufficient information is not available at the acquisition date to measure those amounts, the acquirer determines and recognises provisional amounts until the necessary information becomes available.
- BC391 The boards concluded that providing for retrospective adjustments during the measurement period should help to resolve concerns about the quality and availability of information at the acquisition date for measuring the fair values of particular items at that date. Constituents especially indicated such concerns about contingent liabilities and contingent consideration arrangements, which also affect the amount of goodwill or the gain recognised on a bargain purchase.
- BC392 The boards decided to place constraints on the period for which it is deemed reasonable to be seeking information necessary to complete the accounting for a business combination. The measurement period ends as soon as the acquirer receives the necessary information about facts and circumstances that existed as of the acquisition date or learns that the information is not obtainable. However, in no circumstances may the measurement period exceed one year from the acquisition date. The boards concluded that allowing a measurement period longer than one year would not be especially helpful; obtaining reliable information about circumstances and conditions that existed more than a year ago is likely to become more difficult as time passes. Of course, the outcome of some contingencies and similar matters may not be known within a year. But the objective of the measurement period is to provide time to obtain the information necessary to measure the fair value of the item as of the acquisition date. Determining the ultimate settlement amount of a contingency or other item is not necessary. Uncertainties about the timing and amount of future cash flows are part of the measure of the fair value of an asset or liability.
- BC393 The boards also concluded that acquirers should provide users of their financial statements with relevant information about the status of items that have been measured only provisionally. Thus, paragraph B67(a) of the revised IFRS 3 specifies particular disclosures about those items.
- BC394 Both IFRS 3 and SFAS 141 included a period during which an acquirer might measure particular amounts provisionally if the necessary information was not available at the acquisition date. Neither of those provisions was identical to the measurement period guidance in the revised standards, although IFRS 3's was quite similar. However, the

* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

Effective date and transition for combinations of mutual entities or by contract alone

BC433 IFRS 3 excluded from its scope combinations of mutual entities and those achieved by contract alone. In developing IFRS 3, the IASB decided that these combinations should be excluded from its scope until the IASB published interpretative guidance for the application of the acquisition method to those transactions. The revised IFRS 3 provides that guidance. The effective date for combinations of mutual entities and those achieved by contract alone is the same as the effective date for all other entities applying the revised IFRS 3.

BC434 For the reasons outlined in paragraph BC180 of IFRS 3 the IASB concluded that the transitional provisions for combinations involving mutual entities only or those achieved by contract alone should be prospective. Given that these combinations were not within the scope of IFRS 3, they may have been accounted for differently from what IFRS 3 required. The transitional provisions in IFRS 3 took into consideration that entities may have used a range of alternatives in accounting for combinations in the past. The IASB concluded that the transitional provisions for these combinations should incorporate the transitional provisions in IFRS 3 for other business combinations. In addition, the IASB concluded that the transitional provisions should provide that an entity should continue to classify prior combinations in accordance with its previous accounting for such combinations. This is consistent with the prospective approach. Those provisions are contained in paragraphs B68 and B69 of the revised IFRS 3.

Transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (as revised in 2008)

BC434A In *Improvements to IFRSs* issued in May 2010, the Board addressed a perceived conflict in the guidance on accounting for contingent consideration in a business combination. The perceived conflict related to the transition guidance for contingent consideration arising from business combinations that had been accounted for in accordance with IFRS 3 (as issued in 2004). Before their deletion in January 2008, paragraph 3(c) of IFRS 7, paragraph 4(c) of IAS 32 and paragraph 2(f) of IAS 39* excluded contingent consideration arrangements from the scope of those IFRSs. To allow the acquirer to account for contingent consideration as required by IFRS 3 (revised 2008), the Board deleted those scope exceptions in the second phase of its project on business combinations.

BC434B Some interpreted the deletion of the scope exception as meaning that IAS 39 would apply to all contingent consideration, including contingent consideration from business combinations with an acquisition date earlier than the application date of IFRS 3 (revised 2008). However, this interpretation is inconsistent with the transition guidance in paragraph 65 of IFRS 3 (revised 2008).

BC434C Therefore, the Board reproduced paragraphs 32–35 of IFRS 3 (as issued in 2004) as paragraphs 65B–65E in IFRS 3 (revised 2008) and made the conforming changes to IFRS 7, IAS 32 and IAS 39. The Board did this to clarify that the requirements in IAS 39 do not apply to contingent consideration that arose from a business combination whose acquisition date preceded the application of IFRS 3 (revised 2008) and to provide guidance on how to account for such balances. The Board believes that the amendments will not cause IFRS 3 to diverge from FASB ASC Topic 805 *Business Combinations* (SFAS 141(R) *Business Combinations*).

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations

BC434D *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, clarifies the accounting for contingent consideration that arises from business combinations. The IASB considered whether the transition provisions of paragraph 19 in IAS 8 should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Retrospective application might therefore require the determination of fair value for contingent consideration, which might not have been previously measured at fair value following initial recognition. It may be impracticable for an entity to determine the fair value of such contingent consideration without using hindsight. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. The IASB also decided on a 1 July 2014 mandatory effective date for the amendments to IFRS 3 and the consequential amendments to IAS 37 as well as to IFRS 9 and IAS 39, depending on the financial instruments Standard that is applied by the entity at the time that this amendment becomes effective.

Scope exceptions for joint ventures

BC434E *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 2(a) and added paragraph 64J to clarify the scope exception in paragraph 2(a) of IFRS 3. It took into consideration the transition provisions and effective date of the amendment to IFRS 3. In order to be consistent with the prospective initial application of IFRS 3, the IASB decided that an entity shall apply the amendment to IFRS 3 prospectively for annual periods beginning on or after 1 July 2014.

Benefits and costs

BC435 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgemental process. Furthermore, the costs do not necessarily fall on those who enjoy the benefits. For these reasons, it is difficult to apply a cost-benefit test in any particular case. In making its judgement, the IASB considers:

- (a) the costs incurred by preparers of financial statements;
- (b) the costs incurred by users of financial statements when information is not available;
- (c) the comparative advantage that preparers have in developing information, when compared with the costs that users would incur to develop surrogate information; and
- (d) the benefit of better economic decision-making as a result of improved financial reporting.

In the second phase of the business combinations project the IASB also considered the costs and benefits of the revised IFRS 3 relative to IFRS 3.

BC436 The IASB concluded that the revised IFRS 3 benefits both preparers and users of financial statements by converging to common high quality, understandable and enforceable accounting standards for business combinations in IFRSs and US GAAP. This improves the comparability of financial information around the world and it also simplifies and reduces the costs of accounting for entities that issue financial statements in accordance with both IFRSs and US GAAP.

BC437 The revised IFRS 3 builds on the core principles established by IFRS 3. However, the IASB sought to improve the understandability, relevance, reliability and comparability of information provided to users of financial statements as follows:

(a) **Scope**

The revised IFRS 3 has a broader scope than IFRS 3. Those entities that will now be required to apply the acquisition method might incur additional costs to obtain valuations and account for intangible assets and goodwill after the acquisition date. However, the IASB observes that much of the information required to account for a business combination by applying the acquisition method is already prepared by those entities that are currently applying the pooling of interests method. There might be additional costs associated with presenting this information within the financial statements, such as audit costs, but much of the information will already be available to management. The IASB concluded therefore that the benefits of improved comparability and faithful representation outweigh the costs that those entities will incur.

(b) **Non-controlling interest**

Paragraph 19 of the revised IFRS 3 provides preparers of financial statements with a choice for each business combination to measure initially a non-controlling interest either at fair value or as the non-controlling interest's proportionate share of the acquiree's identifiable net assets. Paragraphs BC209–BC221 discuss the benefits and costs associated with granting a choice on how non-controlling interests should be measured.

(c) **Contingent consideration**

Paragraph 58 of the revised IFRS 3 requires contingent consideration that is classified as a liability and is within the scope of IAS 39[#] to be remeasured to fair value (or for those within the scope of IAS 37 or another IFRS, to be accounted for in accordance with that IFRS)* and that contingent consideration classified as equity is not remeasured. The IASB understands that remeasuring the fair value of contingent consideration after the acquisition date results in additional costs to preparers. Preparers will need to measure the fair value of these arrangements or will need to obtain external valuations at the end of each reporting period. However, users have stated that the information they receive under IFRS 3 is too late to be useful. The IASB concluded therefore that the benefits of relevance and representational faithfulness and the increased information that would be provided to users outweigh the costs.

(d) **Acquisition-related costs**

Paragraph 53 of the revised IFRS 3 requires the costs the acquirer incurs in connection with a business combination to be accounted for separately from the business combination. The IASB concluded that this treatment would improve the understandability of the information provided to users of financial statements. The IASB observed that the new requirement does not create significant additional costs for preparers of financial statements because paragraph 67(d) of IFRS 3 already required disclosure of acquisition-related costs.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

* *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended IFRS 3, IFRS 9, IAS 37 and IAS 39 to clarify that contingent consideration in a business combination that is classified as an asset or a liability shall be subsequently measured at fair value with changes in fair value recognised in profit or loss.

Illustrative Examples and Comparison with SFAS 141(R)
Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

IFRS 3 *Business Combinations*

Illustrative examples

These examples accompany, but are not part of, IFRS 3.

Reverse acquisitions

Illustrating the consequences of recognising a reverse acquisition by applying paragraphs B19–B27 of IFRS 3.

- IE1 This example illustrates the accounting for a reverse acquisition in which Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity instruments and therefore the legal parent, in a reverse acquisition on 30 September 20X6. This example ignores the accounting for any income tax effects.
- IE2 The statements of financial position of Entity A and Entity B immediately before the business combination are:

	Entity A (legal parent, accounting acquiree)	Entity B (legal subsidiary, accounting acquirer)
	CU ^(a)	CU
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
Total shareholders' equity	1,100	2,000
Total liabilities and shareholders' equity	1,800	3,700

^(a) In these examples monetary amounts are denominated in 'currency units (CU)'.

- IE3 This example also uses the following information:

- (a) On 30 September 20X6 Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

Comparison of IFRS 3 (as revised in 2008) and SFAS 141(R)

- 1 IFRS 3 *Business Combinations* (as revised in 2008) and FASB Statement No.141 (revised 2007) *Business Combinations* (SFAS 141(R)) are the result of the IASB's and the FASB's projects to improve the accounting for and reporting of business combinations. The first phase of those projects led to IFRS 3 (issued in 2004) and FASB Statement No. 141 (issued in 2001). In 2002, the IASB and the FASB agreed to reconsider jointly their guidance for applying the purchase method (now called the acquisition method) of accounting for business combinations. The objective of the joint effort was to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and international financial reporting. Although the boards reached the same conclusions on most of the issues addressed in the project, they reached different conclusions on a few matters.
- 2 On those matters on which the boards reached different conclusions, each board includes its own requirements in its version of the standard. The following table identifies and compares those paragraphs in which the IASB and the FASB have different requirements. The table does not identify non-substantive differences. For example, the table does not identify differences in terminology that do not change the meaning of the guidance, such as the IASB using the term *profit or loss* and the FASB using the term *earnings*.
- 3 Most of the differences identified in the table arise because of the boards' decision to provide guidance for accounting for business combinations that is consistent with other IFRSs or FASB standards. Many of those differences are being considered in current projects or are candidates for future convergence projects, which is why the boards allowed those differences to continue at this time.

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Operating leases	The revised IFRS 3 requires the acquirer to take into account the terms of a lease in measuring the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor. This is consistent with the guidance in IAS 40 <i>Investment Property</i> . Accordingly, the revised IFRS 3 does not require the acquirer of an operating lease in which the acquiree is the lessor to recognise a separate asset or liability if the terms of an operating lease are favourable or unfavourable compared with market terms as is required for leases in which the acquiree is the lessee. [paragraphs B29 and B42]	Regardless of whether the acquiree is the lessee or the lessor, SFAS 141(R) requires the acquirer to recognise an intangible asset if the terms of an operating lease are favourable relative to market terms or a liability if the terms are unfavourable relative to market terms. Accordingly, an acquirer measures the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. [paragraphs A17 and A58]
Non-controlling interest in an acquiree [±]	Initial recognition The revised IFRS 3 permits an acquirer to measure the non-controlling interest in an acquiree either at fair value or as its proportionate share of the acquiree's identifiable net assets. [paragraph 19]	Initial recognition SFAS 141(R) requires the non-controlling interest in an acquiree to be measured at fair value. [paragraph 20]

* ~~IFRS 13 (issued in May 2011) defines fair value and contains the requirements for measuring fair value and for disclosing information about fair value measurements. Although the disclosures required by IFRS 13 are not required for IFRS 3, the wording for the disclosures in IFRS 3 has been aligned with the wording in US GAAP (Topic 805 Business Combinations in the FASB Accounting Standards Codification[®] codified FASB Statement No. 141(R)).~~

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Non-controlling interest in an acquiree*	Disclosures Because an acquirer is permitted to choose between two measurement bases for the non-controlling interest in an acquiree, the revised IFRS 3 requires an acquirer to disclose the measurement basis used. If the non-controlling interest is measured at fair value, the acquirer must disclose the valuation techniques and key model inputs used. [paragraph B64(o)]	Disclosures SFAS 141(R) requires an acquirer to disclose the valuation technique(s) and significant inputs used to measure fair value. [paragraph 68(p)]
Assets and liabilities arising from contingencies	Initial recognition The revised IFRS 3 requires the acquirer to recognise a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. [paragraphs 22 and 23]	Initial recognition SFAS 141(R) requires the acquirer to recognise as of the acquisition date the assets acquired and liabilities assumed that arise from <i>contractual contingencies</i>, measured at their acquisition-date fair values. For all other contingencies (referred to as <i>non-contractual contingencies</i>), the acquirer recognises an asset or liability as of the acquisition date if it is more likely than not that the contingency gives rise to an asset or a liability as defined in FASB Concepts Statement No. 6 <i>Elements of Financial Statements</i>. Non-contractual contingencies that do not meet the recognition threshold as of the acquisition date are accounted for in accordance with other GAAP, including FASB Statement No. 5 <i>Accounting for Contingencies</i> (SFAS 5) as appropriate. [paragraphs 23–25]

* IFRS 13 (issued in May 2011) defines fair value and contains the requirements for measuring fair value and for disclosing information about fair value measurements. Although the disclosures required by IFRS 13 are not required for IFRS 3, the wording for the disclosures in IFRS 3 has been aligned with the wording in US GAAP (Topic 805 Business Combinations in the FASB Accounting Standards Codification® codified FASB Statement No. 141(R)).

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Assets and liabilities arising from contingencies	Subsequent measurement The revised IFRS 3 carries forward the existing requirements that a contingent liability recognised in a business combination must be measured subsequently at the higher of the amount that would be recognised in accordance with IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> or the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 <i>Revenue</i>.[*] [paragraph 56]	Subsequent measurement SFAS 141(R) requires an acquirer to continue to report an asset or liability arising from a contractual or non-contractual contingency that is recognised as of the acquisition date that would be in the scope of SFAS 5 if not acquired or assumed in a business combination at its acquisition-date fair value until the acquirer obtains new information about the possible outcome of the contingency. The acquirer evaluates that new information and measures the asset or liability as follows: (a) a liability is measured at the <i>higher</i> of: (i) its acquisition-date fair value; or (ii) the amount that would be recognised if applying SFAS 5. (b) an asset is measured at the <i>lower</i> of: (i) its acquisition-date fair value; or (ii) the best estimate of its future settlement amount. [paragraphs 62 and 63]

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 56 of IFRS 3 for consistency with the requirements in IFRS 15.

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Contingent consideration *	Initial classification The revised IFRS 3 and SFAS 141(R) require an acquirer to classify contingent consideration as an asset, a liability or equity on the basis of other IFRSs or US GAAP, respectively. Differences between the related IFRSs and US GAAP might cause differences in the initial classification and, therefore, might cause differences in the subsequent accounting. [the revised IFRS 3, paragraph 40; SFAS 141(R), paragraph 42]	
	Subsequent measurement Contingent consideration classified as an asset or <u>a</u> liability that: (a) is within the scope of IFRS 9 <i>Financial Instruments</i>, is measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with that IFRS. (b) is not within the scope of IFRS 9, is measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss. [paragraph 58]	Subsequent measurement Contingent consideration classified as an asset or liability is measured subsequently at fair value. The changes in fair value are recognised in earnings unless the contingent consideration is a hedging instrument for which FASB Statement No. 133 <i>Accounting for Derivative Instruments and Hedging Activities</i> requires the subsequent changes to be recognised in other comprehensive income. [paragraph 65]

* *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended IFRS 3, IFRS 9, IAS 37 and IAS 39 to clarify that contingent consideration in a business combination that is classified as an asset or a liability shall be subsequently measured at fair value with changes in fair value recognised in profit or loss.

Hong Kong Financial Reporting Standard 4

Insurance Contracts



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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BASIS FOR CONCLUSIONS

IMPLEMENTATION GUIDANCE

Hong Kong Financial Reporting Standard 4 *Insurance Contracts* (HKFRS 4) is set out in paragraphs 1-49~~5~~ and Appendices A-~~C~~~~B~~ and ~~E~~~~D~~. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 4 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

- IN1 This is the first HKFRS to deal with insurance contracts. Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors. Pursuant to its convergence policy, the Hong Kong Institute of Certified Public Accountants has issued this HKFRS:
- (a) to make limited improvements to accounting for insurance contracts until the International Accounting Standards Board (“the Board”) completes the second phase of its project on insurance contracts.
 - (b) to require any entity issuing insurance contracts (an insurer) to disclose information about those contracts.
- IN2 This HKFRS is converged with IFRS 4, *Insurance Contracts*. IFRS 4 is a stepping stone to phase II of the Board’s project. The Board is committed to completing phase II without delay once it has investigated all relevant conceptual and practical questions and completed its full due process.

Main features of the HKFRS

- IN3 The HKFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other HKFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of HKFRS 9 ~~HKAS 39~~ *Financial Instruments: Recognition and Measurement*. Furthermore, it does not address accounting by policyholders.
- IN4 The HKFRS exempts an insurer temporarily (ie during phase I of this project) from some requirements of other HKFRSs, including the requirement to consider the *Framework*^{*} in selecting accounting policies for insurance contracts. However, the HKFRS:
- (a) prohibits provisions for possible claims under contracts that are not in existence at the end of the reporting period (such as catastrophe and equalisation provisions).
 - (b) requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets.
 - (c) requires an insurer to keep insurance liabilities in its statement of financial position until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.
- IN5 The HKFRS permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. In particular, an insurer cannot introduce any of the following practices, although it may continue

^{*} The reference to the *Framework* is to *Framework for the Preparation and Presentation of Financial Statements* issued by the HKICPA in 1997. In October 2010, the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

using accounting policies that involve them:

- (a) measuring insurance liabilities on an undiscounted basis.
- (b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services.
- (c) using non-uniform accounting policies for the insurance liabilities of subsidiaries.

IN6 The HKFRS permits the introduction of an accounting policy that involves remeasuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

IN7 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

IN8 There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts.

IN9 When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'.

IN10 The HKFRS:

- (a) clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.
- (b) requires an insurer to unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its statement of financial position.
- (c) clarifies the applicability of the practice sometimes known as 'shadow accounting'.
- (d) permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer.
- (e) addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

IN11 The HKFRS requires disclosure to help users understand:

- (a) the amounts in the insurer's financial statements that arise from insurance contracts.
- (b) ~~the amount, timing and uncertainty of future cash flows~~ the nature and extent of risks arising from insurance contracts.

IN12- [Deleted]

IN13

Hong Kong Financial Reporting Standard 4

Insurance Contracts

Objective

- 1 The objective of this HKFRS is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this HKFRS as an *insurer*). In particular, this HKFRS requires:
 - (a) limited improvements to accounting by insurers for insurance contracts.
 - (b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Scope

- 2 An entity shall apply this HKFRS to:
 - (a) insurance contracts (including *reinsurance contracts*) that it issues and reinsurance contracts that it holds.
 - (b) financial instruments that it issues with a *discretionary participation feature* (see paragraph 35). HKFRS 7 *Financial Instruments: Disclosures* requires disclosure about financial instruments, including financial instruments that contain such features.
- 3 This HKFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see HKAS 32 *Financial Instruments Presentation*, ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~ and HKFRS 7 and HKFRS 9 *Financial Instruments*), except:
 - (a) paragraph 20A permits insurers that meet specified criteria to apply a temporary exemption from HKFRS 9;
 - (b) paragraph 35B permits insurers to apply the overlay approach to designated financial assets; and
 - (c) in the transitional provisions in paragraph 45 permits insurers to reclassify in specified circumstances some or all of their financial assets so that the assets are measured at fair value through profit or loss.
4. An entity shall not apply this HKFRS to:
 - (a) product warranties issued directly by a manufacturer, dealer or retailer (see HKFRS 15 *Revenue from Contracts with Customers* ~~HKAS 18 *Revenue*~~ and HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
 - (b) employers' assets and liabilities under employee benefit plans (see HKAS 19 *Employee Benefits* and HKFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see HKAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

- (c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see HKAS 17 *Leases*, HKFRS 15 *Revenue from Contracts with Customers*~~HKAS 18 *Revenue*~~ and HKAS 38 *Intangible Assets*).
 - (d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either ~~HKAS 39~~ and HKAS 32, ~~and~~ HKFRS 7 and HKFRS 9 or this HKFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.
 - (e) contingent consideration payable or receivable in a business combination (see HKFRS 3 *Business Combinations*).
 - (f) *direct insurance contracts* that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply this HKFRS to reinsurance contracts that it holds.
- 5 For ease of reference, this HKFRS describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes. All reference in paragraphs 3(a)-3(b), 20A-20Q, 35B-35N, 39B-39M and 46-49 to an insurer shall be read as also referring to an issuer of a financial instrument that contains a discretionary participation feature.
- 6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this HKFRS to insurance contracts also apply to reinsurance contracts.

Embedded derivatives

- 7 HKFRS 9~~HKAS 39~~ requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in profit or loss. HKFRS 9~~HKAS 39~~ applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.
- 8 As an exception to the requirements in HKFRS 9~~HKAS 39~~, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirements in HKFRS 9~~HKAS 39~~ do apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, those requirement also apply if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).
- 9 Paragraph 8 applies equally to options to surrender a financial instrument containing a discretionary participation feature.

Unbundling of deposit components

- 10 Some insurance contracts contain both an insurance component and a *deposit component*. In some cases, an insurer is required or permitted to *unbundle* those components:
- (a) unbundling is required if both the following conditions are met:

- (i) the insurer can measure the deposit component (including any embedded surrender options) separately (ie without considering the insurance component).
 - (ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
 - (b) unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
 - (c) unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).
- 11 The following is an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. A cedant receives compensation for losses from a *reinsurer*, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant's accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required.
- 12 To unbundle a contract, an insurer shall:
- (a) apply this HKFRS to the insurance component.
 - (b) apply HKFRS 9~~HKAS 39~~ to the deposit component.

Recognition and measurement

Temporary exemption from some other HKFRSs

- 13 Paragraphs 10-12 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy if no HKFRS applies specifically to an item. However, this HKFRS exempts an insurer from applying those criteria to its accounting policies for:
- (a) insurance contracts that it issues (including related acquisition costs and related intangible assets, such as those described in paragraphs 31 and 32); and
 - (b) reinsurance contracts that it holds.
- 14 Nevertheless, this HKFRS does not exempt an insurer from some implications of the criteria in paragraphs 10-12 of HKAS 8. Specifically, an insurer:
- (a) shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period (such as catastrophe provisions and equalisation provisions).
 - (b) shall carry out the *liability adequacy test* described in paragraphs 15-19.

- (c) shall remove an insurance liability (or a part of an insurance liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.
- (d) shall not offset:
 - (i) *reinsurance assets* against the related insurance liabilities; or
 - (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.
- (e) shall consider whether its reinsurance assets are impaired (see paragraph 20).

Liability adequacy test

- 15 An insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.**
16. If an insurer applies a liability adequacy test that meets specified minimum requirements, this HKFRS imposes no further requirements. The minimum requirements are the following:
- (a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.
 - (b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.
- 17 If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall:
- (a) determine the carrying amount of the relevant insurance liabilities* less the carrying amount of:
 - (i) any related deferred acquisition costs; and
 - (ii) any related intangible assets, such as those acquired in a business combination or portfolio transfer (see paragraphs 31 and 32). However, related reinsurance assets are not considered because an insurer accounts for them separately (see paragraph 20).

* The relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16.

- (b) determine whether the amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of HKAS 37. If it is less, the insurer shall recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.
- 18 If an insurer's liability adequacy test meets the minimum requirements of paragraph 16, the test is applied at the level of aggregation specified in that test. If its liability adequacy test does not meet those minimum requirements, the comparison described in paragraph 17 shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio.
- 19 The amount described in paragraph 17(b) (ie the result of applying HKAS 37) shall reflect future investment margins (see paragraphs 27-29) if, and only if, the amount described in paragraph 17(a) also reflects those margins.

Impairment of reinsurance assets

- 20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:
- (a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and
 - (b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Temporary exemption from HKFRS 9

20A HKFRS 9 addresses the accounting for financial instruments and is effective for annual periods beginning on or after 1 January 2018. However, for an insurer that meets the criteria in paragraph 20B, this HKFRS provides a temporary exemption that permits, but does not require, the insurer to apply HKAS 39 *Financial Instruments: Recognition and Measurement* rather than HKFRS 9 for annual periods beginning before 1 January 2021. An insurer that applies the temporary exemption from HKFRS 9 shall:

- (a) use the requirements in HKFRS 9 that are necessary to provide the disclosures required in paragraphs 39B–39J of this HKFRS; and**
- (b) apply all other applicable HKFRSs to its financial instruments, except as described in paragraphs 20A–20Q, 39B–39J and 46–47 of this HKFRS.**

20B An insurer may apply the temporary exemption from HKFRS 9 if, and only if:

- (a) it has not previously applied any version of HKFRS 9^Ω, other than only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of HKFRS 9; and**

^Ω The HKICPA issued successive versions of HKFRS 9 in 2009, 2010, 2013 –and 2014.

(b) its activities are predominantly connected with insurance, as described in paragraph 20D, at its annual reporting date that immediately precedes 1 April 2016, or at a subsequent annual reporting date as specified in paragraph 20G.

20C An insurer applying the temporary exemption from HKFRS 9 is permitted to elect to apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of HKFRS 9. If an insurer elects to apply those requirements, it shall apply the relevant transition provisions in HKFRS 9, disclose the fact that it has applied those requirements and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of HKFRS 7 (as amended by HKFRS 9 (2010)).

20D An insurer's activities are predominantly connected with insurance if, and only if:

- (a) the carrying amount of its liabilities arising from contracts within the scope of this HKFRS, which includes any deposit components or embedded derivatives unbundled from insurance contracts applying paragraphs 7–12 of this HKFRS, is significant compared to the total carrying amount of all its liabilities; and
- (b) the percentage of the total carrying amount of its liabilities connected with insurance (see paragraph 20E) relative to the total carrying amount of all its liabilities is:
 - (i) greater than 90 per cent; or
 - (ii) less than or equal to 90 per cent but greater than 80 per cent, and the insurer does not engage in a significant activity unconnected with insurance (see paragraph 20F).

20E For the purposes of applying paragraph 20D(b), liabilities connected with insurance comprise:

- (a) liabilities arising from contracts within the scope of this HKFRS, as described in paragraph 20D(a);
- (b) non-derivative investment contract liabilities measured at fair value through profit or loss applying HKAS 39 (including those designated as at fair value through profit or loss to which the insurer has applied the requirements in HKFRS 9 for the presentation of gains and losses (see paragraphs 20B(a) and 20C)); and
- (c) liabilities that arise because the insurer issues, or fulfils obligations arising from, the contracts in (a) and (b). Examples of such liabilities include derivatives used to mitigate risks arising from those contracts and from the assets backing those contracts, relevant tax liabilities such as the deferred tax liabilities for taxable temporary differences on liabilities arising from those contracts, and debt instruments issued that are included in the insurer's regulatory capital.

20F In assessing whether it engages in a significant activity unconnected with insurance for the purposes of applying paragraph 20D(b)(ii), an insurer shall consider:

- (a) only those activities from which it may earn income and incur expenses; and
- (b) quantitative or qualitative factors (or both), including publicly available information such as the industry classification that users of financial statements apply to the insurer.

20G Paragraph 20B(b) requires an entity to assess whether it qualifies for the temporary exemption from HKFRS 9 at its annual reporting date that immediately precedes 1 April 2016. After that date:

- (a) an entity that previously qualified for the temporary exemption from HKFRS 9 shall reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date if, and only if, there was a change in the entity's activities, as described in paragraphs 20H–20I, during the annual period that ended on that date.
- (b) an entity that previously did not qualify for the temporary exemption from HKFRS 9 is permitted to reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date before 31 December 2018 if, and only if, there was a change in the entity's activities, as described in paragraphs 20H–20I, during the annual period that ended on that date.

20H For the purposes of applying paragraph 20G, a change in an entity's activities is a change that:

- (a) is determined by the entity's senior management as a result of external or internal changes;
- (b) is significant to the entity's operations; and
- (c) is demonstrable to external parties.

Accordingly, such a change occurs only when the entity begins or ceases to perform an activity that is significant to its operations or significantly changes the magnitude of one of its activities; for example, when the entity has acquired, disposed of or terminated a business line.

20I A change in an entity's activities, as described in paragraph 20H, is expected to be very infrequent. The following are not changes in an entity's activities for the purposes of applying paragraph 20G:

- (a) a change in the entity's funding structure that in itself does not affect the activities from which the entity earns income and incurs expenses.
- (b) the entity's plan to sell a business line, even if the assets and liabilities are classified as held for sale applying HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. A plan to sell a business line could change the entity's activities and give rise to a reassessment in the future but has yet to affect the liabilities recognised on its statement of financial position.

20J If an entity no longer qualifies for the temporary exemption from HKFRS 9 as a result of a reassessment (see paragraph 20G(a)), then the entity is permitted to continue to apply the temporary exemption from HKFRS 9 only until the end of the

annual period that began immediately after that reassessment. Nevertheless, the entity must apply HKFRS 9 for annual periods beginning on or after 1 January 2021. For example, if an entity determines that it no longer qualifies for the temporary exemption from HKFRS 9 applying paragraph 20G(a) on 31 December 2018 (the end of its annual period), then the entity is permitted to continue to apply the temporary exemption from HKFRS 9 only until 31 December 2019.

- 20K An insurer that previously elected to apply the temporary exemption from HKFRS 9 may at the beginning of any subsequent annual period irrevocably elect to apply HKFRS 9.

First-time adopter

- 20L A first-time adopter, as defined in HKFRS 1 *First-time Adoption of International Financial Reporting Standards*, may apply the temporary exemption from HKFRS 9 described in paragraph 20A if, and only if, it meets the criteria described in paragraph 20B. In applying paragraph 20B(b), the first-time adopter shall use the carrying amounts determined applying HKFRSs at the date specified in that paragraph.
- 20M HKFRS 1 contains requirements and exemptions applicable to a first-time adopter. Those requirements and exemptions (for example, paragraphs D16–D17 of HKFRS 1) do not override the requirements in paragraphs 20A–20Q and 39B–39J of this HKFRS. For example, the requirements and exemptions in HKFRS 1 do not override the requirement that a first-time adopter must meet the criteria specified in paragraph 20L to apply the temporary exemption from HKFRS 9.
- 20N A first-time adopter that discloses the information required by paragraphs 39B–39J shall use the requirements and exemptions in HKFRS 1 that are relevant to making the assessments required for those disclosures.

Temporary exemption from specific requirements in HKAS 28

- 20O Paragraphs 35–36 of HKAS 28 *Investments in Associates and Joint Ventures* require an entity to apply uniform accounting policies when using the equity method. Nevertheless, for annual periods beginning before 1 January 2021, an entity is permitted, but not required, to retain the relevant accounting policies applied by the associate or joint venture as follows:
- (a) the entity applies HKFRS 9 but the associate or joint venture applies the temporary exemption from HKFRS 9; or
 - (b) the entity applies the temporary exemption from HKFRS 9 but the associate or joint venture applies HKFRS 9.
- 20P When an entity uses the equity method to account for its investment in an associate or joint venture:
- (a) if HKFRS 9 was previously applied in the financial statements used to apply the equity method to that associate or joint venture (after reflecting any adjustments made by the entity), then HKFRS 9 shall continue to be applied.
 - (b) if the temporary exemption from HKFRS 9 was previously applied in the financial statements used to apply the equity method to that associate or joint venture (after reflecting any adjustments made by the entity), then HKFRS 9 may be subsequently applied.

20Q An entity may apply paragraphs 20O and 20P(b) separately for each associate or joint venture.

Changes in accounting policies

- 21 Paragraphs 22-30 apply both to changes made by an insurer that already applies HKFRSs and to changes made by an insurer adopting HKFRSs for the first time.
- 22 **An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in HKAS 8.**
- 23 To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in HKAS 8, but the change need not achieve full compliance with those criteria. The following specific issues are discussed below:
- (a) current interest rates (paragraph 24);
 - (b) continuation of existing practices (paragraph 25);
 - (c) prudence (paragraph 26);
 - (d) future investment margins (paragraphs 27-29); and
 - (e) shadow accounting (paragraph 30).

Current market interest rates

- 24 An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities* to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as HKAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all these liabilities until they are extinguished.

Continuation of existing practices

- 25 An insurer may continue the following practices, but the introduction of any of them does not satisfy paragraph 22:
- (a) measuring insurance liabilities on an undiscounted basis.
 - (b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current

* In this paragraph, insurance liabilities include related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32.

fees charged by other market participants for similar services. It is likely that the fair value at inception of those contractual rights equals the origination costs paid, unless future investment management fees and related costs are out of line with market comparables.

- (c) using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries, except as permitted by paragraph 24. If those accounting policies are not uniform, an insurer may change them if the change does not make the accounting policies more diverse and also satisfies the other requirements in this HKFRS.

Prudence

- 26 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.

Future investment margins

- 27 An insurer need not change its accounting policies for insurance contracts to eliminate future investment margins. However, there is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts, unless those margins affect the contractual payments. Two examples of accounting policies that reflect those margins are:

- (a) using a discount rate that reflects the estimated return on the insurer's assets; or
- (b) projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability.

- 28 An insurer may overcome the rebuttable presumption described in paragraph 27 if, and only if, the other components of a change in accounting policies increase the relevance and reliability of its financial statements sufficiently to outweigh the decrease in relevance and reliability caused by the inclusion of future investment margins. For example, suppose that an insurer's existing accounting policies for insurance contracts involve excessively prudent assumptions set at inception and a discount rate prescribed by a regulator without direct reference to market conditions, and ignore some embedded options and guarantees. The insurer might make its financial statements more relevant and no less reliable by switching to a comprehensive investor-oriented basis of accounting that is widely used and involves:

- (a) current estimates and assumptions;
- (b) a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty;
- (c) measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and

- (d) a current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets.

29 In some measurement approaches, the discount rate is used to determine the present value of a future profit margin. That profit margin is then attributed to different periods using a formula. In those approaches, the discount rate affects the measurement of the liability only indirectly. In particular, the use of a less appropriate discount rate has a limited or no effect on the measurement of the liability at inception. However, in other approaches, the discount rate determines the measurement of the liability directly. In the latter case, because the introduction of an asset-based discount rate has a more significant effect, it is highly unlikely that an insurer could overcome the rebuttable presumption described in paragraph 27.

Shadow accounting

30 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income. This practice is sometimes described as 'shadow accounting'.

Insurance contracts acquired in a business combination or portfolio transfer

31 To comply with HKFRS 3, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance assets* acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
- (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

32 An insurer acquiring a portfolio of insurance contracts may use the expanded presentation described in paragraph 31.

33 The intangible assets described in paragraphs 31 and 32 are excluded from the scope of HKAS 36 *Impairment of Assets* and HKAS 38. However, HKAS 36 and HKAS 38 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination or portfolio transfer.

Discretionary participation features

Discretionary participation features in insurance contracts

- 34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:
- (a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. If the issuer classifies them separately, it shall classify the guaranteed element as a liability.
 - (b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This HKFRS does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity.
 - (c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to non-controlling interests). The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see HKAS 1 *Presentation of Financial Statements*).
 - (d) shall, if the contract contains an embedded derivative within the scope of ~~HKFRS 9~~~~HKAS 39~~, apply ~~HKFRS 9~~~~HKAS 39~~ to that embedded derivative.
 - (e) shall, in all respects not described in paragraphs 14-20 and 34(a)-(d), continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with paragraphs 21-30.

Discretionary participation features in financial instruments

- 35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:
- (a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15-19 to the whole contract (ie both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying ~~HKFRS 9~~~~HKAS 39~~ to the guaranteed element.
 - (b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying ~~HKFRS 9~~~~HKAS 39~~ to the guaranteed element. That amount shall include the intrinsic value of an option

to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying ~~HKFRS 9~~~~HKAS 39~~ to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher.

- (c) although these contracts are financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability.
- (d) although these contracts are financial instruments, an issuer applying paragraph 20(b) of HKFRS 7 to contracts with a discretionary participation feature shall disclose the total interest expense recognised in profit or loss, but need not calculate such interest expense using the effective interest method.

35A The temporary exemptions in paragraphs 20A, 20L and 20O and the overlay approach in paragraph 35B are also available to an issuer of a financial instrument that contains a discretionary participation feature. Accordingly, all references in paragraphs 3(a)–3(b), 20A–20Q, 35B–35N, 39B–39M and 46–49 to an insurer shall be read as also referring to an issuer of a financial instrument that contains a discretionary participation feature.

Presentation

The overlay approach

35B An insurer is permitted, but not required, to apply the overlay approach to designated financial assets. An insurer that applies the overlay approach shall:

- (a) reclassify between profit or loss and other comprehensive income an amount that results in the profit or loss at the end of the reporting period for the designated financial assets being the same as if the insurer had applied HKAS 39 to the designated financial assets. Accordingly, the amount reclassified is equal to the difference between:

- (i) the amount reported in profit or loss for the designated financial assets applying HKFRS 9; and
- (ii) the amount that would have been reported in profit or loss for the designated financial assets if the insurer had applied HKAS 39.

- (b) apply all other applicable HKFRSs to its financial instruments, except as described in paragraphs 35B–35N, 39K–39M and 48–49 of this HKFRS.

35C An insurer may elect to apply the overlay approach described in paragraph 35B only when it first applies HKFRS 9, including when it first applies HKFRS 9 after previously applying:

- (a) the temporary exemption from HKFRS 9 described in paragraph 20A;
or

(b) only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of HKFRS 9.

35D An insurer shall present the amount reclassified between profit or loss and other comprehensive income applying the overlay approach:

- (a) in profit or loss as a separate line item; and
- (b) in other comprehensive income as a separate component of other comprehensive income.

35E A financial asset is eligible for designation for the overlay approach if, and only if, the following criteria are met:

- (a) it is measured at fair value through profit or loss applying HKFRS 9 but would not have been measured at fair value through profit or loss in its entirety applying HKAS 39; and
- (b) it is not held in respect of an activity that is unconnected with contracts within the scope of this HKFRS. Examples of financial assets that would not be eligible for the overlay approach are those assets held in respect of banking activities or financial assets held in funds relating to investment contracts that are outside the scope of this HKFRS.

35F An insurer may designate an eligible financial asset for the overlay approach when it elects to apply the overlay approach (see paragraph 35C). Subsequently, it may designate an eligible financial asset for the overlay approach when, and only when:

- (a) that asset is initially recognised; or
- (b) that asset newly meets the criterion in paragraph 35E(b) having previously not met that criterion.

35G An insurer is permitted to designate eligible financial assets for the overlay approach applying paragraph 35F on an instrument-by-instrument basis.

35H When relevant, for the purposes of applying the overlay approach to a newly designated financial asset applying paragraph 35F(b):

- (a) its fair value at the date of designation shall be its new amortised cost carrying amount; and
- (b) the effective interest rate shall be determined based on its fair value at the date of designation.

35I An entity shall continue to apply the overlay approach to a designated financial asset until that financial asset is derecognised. However, an entity:

- (a) shall de-designate a financial asset when the financial asset no longer meets the criterion in paragraph 35E(b). For example, a financial asset will no longer meet that criterion when an entity transfers that asset so that it is held in respect of its banking activities or when an entity ceases to be an insurer.

(b) may, at the beginning of any annual period, stop applying the overlay approach to all designated financial assets. An entity that elects to stop applying the overlay approach shall apply HKAS 8 to account for the change in accounting policy.

35J When an entity de-designates a financial asset applying paragraph 35I(a), it shall reclassify from accumulated other comprehensive income to profit or loss as a reclassification adjustment (see HKAS 1) any balance relating to that financial asset.

35K If an entity stops using the overlay approach applying the election in paragraph 35I(b) or because it is no longer an insurer, it shall not subsequently apply the overlay approach. An insurer that has elected to apply the overlay approach (see paragraph 35C) but has no eligible financial assets (see paragraph 35E) may subsequently apply the overlay approach when it has eligible financial assets.

Interaction with other requirements

35L Paragraph 30 of this HKFRS permits a practice that is sometimes described as 'shadow accounting'. If an insurer applies the overlay approach, shadow accounting may be applicable.

35M Reclassifying an amount between profit or loss and other comprehensive income applying paragraph 35B may have consequential effects for including other amounts in other comprehensive income, such as income taxes. An insurer shall apply the relevant HKFRS, such as HKAS 12 *Income Taxes*, to determine any such consequential effects.

First-time adopter

35N If a first-time adopter elects to apply the overlay approach, it shall restate comparative information to reflect the overlay approach if, and only if, it restates comparative information to comply with HKFRS 9 (see paragraphs E1–E2 of HKFRS 1).

Disclosure

Explanation of recognised amounts

36 **An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts.**

37 To comply with paragraph 36, an insurer shall disclose:

- (a) its accounting policies for insurance contracts and related assets, liabilities, income and expense.
- (b) the recognised assets, liabilities, income and expense (and, if it presents its statement of cash flows using the direct method, cash flows) arising from insurance contracts. Furthermore, if the insurer is a cedant, it shall disclose:
 - (i) gains and losses recognised in profit or loss on buying reinsurance; and
 - (ii) if the cedant defers and amortises gains and losses arising on buying

reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.

- (c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b). When practicable, an insurer shall also give quantified disclosure of those assumptions.
- (d) the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.
- (e) reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

Nature and extent of risks arising from insurance contracts

38 An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.

39 To comply with paragraph 38, an insurer shall disclose:

- (a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
- (b) [deleted]
- (c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:
 - (i) sensitivity to insurance risk (see paragraph 39A).
 - (ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (eg type of insured event, geographical area, or currency).
 - (iii) actual claims compared with previous estimates (ie claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year.
- (d) information about credit risk, liquidity risk and market risk that paragraphs 31-42 of HKFRS 7 would require if the insurance contracts were within the scope of HKFRS 7. However:
 - (i) an insurer need not provide the maturity analyses required by paragraph 39(a) and (b) of HKFRS 7 if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead. This may take the form of an

analysis, by estimated timing, of the amounts recognised in the statement of financial position.

- (ii) if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may use that sensitivity analysis to meet the requirement in paragraph 40(a) of HKFRS 7. Such an insurer shall also provide the disclosures required by paragraph 41 of HKFRS 7.
 - (e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.
- 39A To comply with paragraph 39(c)(i), an insurer shall disclose either (a) or (b) as follows:
- (a) a sensitivity analysis that shows how profit or loss and equity would have been affected if changes in the relevant risk variable that were reasonably possible at the end of the reporting period had occurred; the methods and assumptions used in preparing the sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by paragraph 41 of HKFRS 7.
 - (b) qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows.

Disclosures about the temporary exemption from HKFRS 9

39B An insurer that elects to apply the temporary exemption from HKFRS 9 shall disclose information to enable users of financial statements:

- (a) to understand how the insurer qualified for the temporary exemption; and**
- (b) to compare insurers applying the temporary exemption with entities applying HKFRS 9.**

39C To comply with paragraph 39B(a), an insurer shall disclose the fact that it is applying the temporary exemption from HKFRS 9 and how the insurer concluded on the date specified in paragraph 20B(b) that it qualifies for the temporary exemption from HKFRS 9, including:

- (a) if the carrying amount of its liabilities arising from contracts within the scope of this HKFRS (ie those liabilities described in paragraph 20E(a)) was less than or equal to 90 per cent of the total carrying amount of all its liabilities, the nature and carrying amounts of the liabilities connected with insurance that are not liabilities arising from contracts within the scope of this HKFRS (ie those liabilities described in paragraphs 20E(b) and 20E(c));**
- (b) if the percentage of the total carrying amount of its liabilities connected with insurance relative to the total carrying amount of all its liabilities was less**

than or equal to 90 per cent but greater than 80 per cent, how the insurer determined that it did not engage in a significant activity unconnected with insurance, including what information it considered; and

(c) if the insurer qualified for the temporary exemption from HKFRS 9 on the basis of a reassessment applying paragraph 20G(b):

(i) the reason for the reassessment;

(ii) the date on which the relevant change in its activities occurred; and

(iii) a detailed explanation of the change in its activities and a qualitative description of the effect of that change on the insurer's financial statements.

39D If, applying paragraph 20G(a), an entity concludes that its activities are no longer predominantly connected with insurance, it shall disclose the following information in each reporting period before it begins to apply HKFRS 9:

(a) the fact that it no longer qualifies for the temporary exemption from HKFRS 9;

(b) the date on which the relevant change in its activities occurred; and

(c) a detailed explanation of the change in its activities and a qualitative description of the effect of that change on the entity's financial statements.

39E To comply with paragraph 39B(b), an insurer shall disclose the fair value at the end of the reporting period and the amount of change in the fair value during that period for the following two groups of financial assets separately:

(a) financial assets with contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (ie financial assets that meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of HKFRS 9), excluding any financial asset that meets the definition of held for trading in HKFRS 9, or that is managed and whose performance is evaluated on a fair value basis (see paragraph B4.1.6 of HKFRS 9).

(b) all financial assets other than those specified in paragraph 39E(a); that is, any financial asset:

(i) with contractual terms that do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;

(ii) that meets the definition of held for trading in HKFRS 9; or

(iii) that is managed and whose performance is evaluated on a fair value basis.

39F When disclosing the information in paragraph 39E, the insurer:

(a) may deem the carrying amount of the financial asset measured applying HKAS 39 to be a reasonable approximation of its fair value if the insurer is

not required to disclose its fair value applying paragraph 29(a) of HKFRS 7 (eg short-term trade receivables); and

- (b) shall consider the level of detail necessary to enable users of financial statements to understand the characteristics of the financial assets.

39G To comply with paragraph 39B(b), an insurer shall disclose information about the credit risk exposure, including significant credit risk concentrations, inherent in the financial assets described in paragraph 39E(a). At a minimum, an insurer shall disclose the following information for those financial assets at the end of the reporting period:

- (a) by credit risk rating grades as defined in HKFRS 7, the carrying amounts applying HKAS 39 (in the case of financial assets measured at amortised cost, before adjusting for any impairment allowances).
- (b) for the financial assets described in paragraph 39E(a) that do not have low credit risk at the end of the reporting period, the fair value and the carrying amount applying HKAS 39 (in the case of financial assets measured at amortised cost, before adjusting for any impairment allowances). For the purposes of this disclosure, paragraph B5.5.22 of HKFRS 9 provides the relevant requirements for assessing whether the credit risk on a financial instrument is considered low.

39H To comply with paragraph 39B(b), an insurer shall disclose information about where a user of financial statements can obtain any publicly available HKFRS 9 information that relates to an entity within the group that is not provided in the group's consolidated financial statements for the relevant reporting period. For example, such HKFRS 9 information could be obtained from the publicly available individual or separate financial statements of an entity within the group that has applied HKFRS 9.

39I If an entity elected to apply the exemption in paragraph 200 from particular requirements in HKAS 28, it shall disclose that fact.

39J If an entity applied the temporary exemption from HKFRS 9 when accounting for its investment in an associate or joint venture using the equity method (for example, see paragraph 200(a)), the entity shall disclose the following, in addition to the information required by HKFRS 12 *Disclosure of Interests in Other Entities*:

- (a) the information described by paragraphs 39B–39H for each associate or joint venture that is material to the entity. The amounts disclosed shall be those included in the HKFRS financial statements of the associate or joint venture after reflecting any adjustments made by the entity when using the equity method (see paragraph B14(a) of HKFRS 12), rather than the entity's share of those amounts.
- (b) the quantitative information described by paragraphs 39B–39H in aggregate for all individually immaterial associates or joint ventures. The aggregate amounts:
- (i) disclosed shall be the entity's share of those amounts; and
- (ii) for associates shall be disclosed separately from the aggregate amounts disclosed for joint ventures.

Disclosures about the overlay approach

39K An insurer that applies the overlay approach shall disclose information to enable users of financial statements to understand:

- (a) how the total amount reclassified between profit or loss and other comprehensive income in the reporting period is calculated; and**
- (b) the effect of that reclassification on the financial statements.**

39L To comply with paragraph 39K, an insurer shall disclose:

- (a) the fact that it is applying the overlay approach;
- (b) the carrying amount at the end of the reporting period of financial assets to which the insurer applies the overlay approach by class of financial asset;
- (c) the basis for designating financial assets for the overlay approach, including an explanation of any designated financial assets that are held outside the legal entity that issues contracts within the scope of this HKFRS;
- (d) an explanation of the total amount reclassified between profit or loss and other comprehensive income in the reporting period in a way that enables users of financial statements to understand how that amount is derived, including:
 - (i) the amount reported in profit or loss for the designated financial assets applying HKFRS 9; and
 - (ii) the amount that would have been reported in profit or loss for the designated financial assets if the insurer had applied HKAS 39.
- (e) the effect of the reclassification described in paragraphs 35B and 35M on each affected line item in profit or loss; and
- (f) if during the reporting period the insurer has changed the designation of financial assets:
 - (i) the amount reclassified between profit or loss and other comprehensive income in the reporting period relating to newly designated financial assets applying the overlay approach (see paragraph 35F(b));
 - (ii) the amount that would have been reclassified between profit or loss and other comprehensive income in the reporting period if the financial assets had not been de-designated (see paragraph 35I(a)); and
 - (iii) the amount reclassified in the reporting period to profit or loss from accumulated other comprehensive income for financial assets that have been de-designated (see paragraph 35J).

39M If an entity applied the overlay approach when accounting for its investment in an associate or joint venture using the equity method, the entity shall disclose the following, in addition to the information required by HKFRS 12:

- (a) the information described by paragraphs 39K–39L for each associate or joint venture that is material to the entity. The amounts disclosed shall be those included in the HKFRS financial statements of the associate or joint venture after reflecting any adjustments made by the entity when using the equity method (see paragraph B14(a) of HKFRS 12), rather than the entity’s share of those amounts.
- (b) the quantitative information described by paragraphs 39K–39L(d) and 39L(f), and the effect of the reclassification described in paragraph 35B on profit or loss and other comprehensive income in aggregate for all individually immaterial associates or joint ventures. The aggregate amounts:
- (i) disclosed shall be the entity’s share of those amounts; and
- (ii) for associates shall be disclosed separately from the aggregate amounts disclosed for joint ventures.

Effective date and transition

- 40 The transitional provisions in paragraphs 41–49~~5~~ apply both to an entity that is already applying HKFRSs when it first applies this HKFRS and to an entity that applies HKFRSs for the first-time (a first-time adopter).
- 41 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this HKFRS for an earlier period, it shall disclose that fact.
- 41A *Financial Guarantee Contracts* (Amendments to HKAS 39 and HKFRS 4), issued in September 2005, amended paragraphs 4(d), B18(g) and B19(f). An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies those amendments for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 39 and HKAS 32* at the same time.
- 41B HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 30. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 41C ~~[Deleted] [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 41D ~~[Deleted] [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~
- 41E *HKFRS 13 Fair Value Measurement*, issued in June 2011, amended the definition of fair value in Appendix A. An entity shall apply that amendment when it applies HKFRS 13.
- 41F ~~[Deleted]~~
- 41G HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 4(a) and (c), B7, B18(h), B21 and items 1.16 and 1.18 of the table in

* When an entity applies HKFRS 7, the reference to HKAS 32 is replaced by a reference to HKFRS 7.

paragraph IG2. An entity shall apply those amendments when it applies HKFRS 15.

- 41H HKFRS 9, as issued in September 2014, amended paragraphs 3, 4, 7, 8, 12, 34, 35, 45, Appendix A and paragraphs B18–B20 and deleted paragraphs 41C, 41D and 41F. An entity shall apply those amendments when it applies HKFRS 9.

Disclosure

- 42 An entity need not apply the disclosure requirements in this HKFRS to comparative information that relates to annual periods beginning before 1 January 2005, except for the disclosures required by paragraph 37(a) and (b) about accounting policies, and recognised assets, liabilities, income and expense (and cash flows if the direct method is used).
- 43 If it is impracticable to apply a particular requirement of paragraphs 10-35 to comparative information that relates to annual periods beginning before 1 January 2005, an entity shall disclose that fact. Applying the liability adequacy test (paragraphs 15-19) to such comparative information might sometimes be impracticable, but it is highly unlikely to be impracticable to apply other requirements of paragraphs 10-35 to such comparative information. HKAS 8 explains the term ‘impracticable’.
- 44 In applying paragraph 39(c)(iii), an entity need not disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies this HKFRS. Furthermore, if it is impracticable, when an entity first applies this HKFRS, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with this HKFRS, the entity shall disclose that fact.

Redesignation of financial assets

- 45 Notwithstanding paragraph 4.4.1 of HKFRS 9, ~~When~~ an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets so that they are measured as ‘at fair value through profit or loss’. This reclassification is permitted if an insurer changes accounting policies when it first applies this HKFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and HKAS 8 applies.

Applying HKFRS 4 with HKFRS 9

Temporary exemption from HKFRS 9

- 46 Applying HKFRS 9 Financial Instruments with HKFRS 4 Insurance Contracts (Amendments to HKFRS 4), issued in January 2017, amended paragraphs 3 and 5, and added paragraphs 20A–20Q, 35A and 39B–39J and headings after paragraphs 20, 20K, 20N and 39A. An entity shall apply those amendments, which permit insurers that meet specified criteria to apply a temporary exemption from HKFRS 9, for annual periods beginning on or after 1 January 2018.
- 47 An entity that discloses the information required by paragraphs 39B–39J shall use the transitional provisions in HKFRS 9 that are relevant to making the assessments required for those disclosures. The date of initial application for that purpose shall be deemed to be the beginning of the first annual period beginning on or after 1 January 2018.

The overlay approach

48 Applying HKFRS 9 Financial Instruments with HKFRS 4 Insurance Contracts (Amendments to HKFRS 4), issued in January 2017, amended paragraphs 3 and 5, and added paragraphs 35A–35N and 39K–39M and headings after paragraphs 35A, 35K, 35M and 39J. An entity shall apply those amendments, which permit insurers to apply the overlay approach to designated financial assets, when it first applies HKFRS 9 (see paragraph 35C).

49 An entity that elects to apply the overlay approach shall:

- (a) apply that approach retrospectively to designated financial assets on transition to HKFRS 9. Accordingly, for example, the entity shall recognise as an adjustment to the opening balance of accumulated other comprehensive income an amount equal to the difference between the fair value of the designated financial assets determined applying HKFRS 9 and their carrying amount determined applying HKAS 39.
- (b) restate comparative information to reflect the overlay approach if, and only if, the entity restates comparative information applying HKFRS 9.

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

cedant	The policyholder under a reinsurance contract .
deposit component	A contractual component that is not accounted for as a derivative under ~~HKFRS 9~~ ~~HKAS 39~~ and would be within the scope of ~~HKFRS 9~~ ~~HKAS 39~~ if it were a separate instrument.
direct insurance contract	An insurance contract that is not a reinsurance contract .
discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
fair value	<i>Fair value</i> is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13.)
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
guaranteed benefits	Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

guaranteed element	An obligation to pay guaranteed benefits , included in a contract that contains a discretionary participation feature .
insurance asset	An insurer's net contractual rights under an insurance contract .
insurance contract	A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix B for guidance on this definition.)
insurance liability	An insurer's net contractual obligations under an insurance contract .
insurance risk	Risk, other than financial risk , transferred from the holder of a contract to the issuer.
insured event	An uncertain future event that is covered by an insurance contract and creates insurance risk .
insurer	The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.
liability adequacy test	An assessment of whether the carrying amount of an insurance liability needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.
policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs.
reinsurance assets	A cedant's net contractual rights under a reinsurance contract .
reinsurance contract	An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.
reinsurer	The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.
unbundle	Account for the components of a contract as if they were separate contracts.

Appendix B

Definition of an insurance contract

This appendix is an integral part of the HKFRS.

- B1 This appendix gives guidance on the definition of an insurance contract in Appendix A. It addresses the following issues:
- (a) the term ‘uncertain future event’ (paragraphs B2-B4);
 - (b) payments in kind (paragraphs B5-B7);
 - (c) insurance risk and other risks (paragraphs B8-B17);
 - (d) examples of insurance contracts (paragraphs B18-B21);
 - (e) significant insurance risk (paragraphs B22-B28); and
 - (f) changes in the level of insurance risk (paragraphs B29 and B30).

Uncertain future event

- B2 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
- (a) whether an *insured event* will occur;
 - (b) when it will occur; or
 - (c) how much the insurer will need to pay if it occurs.
- B3 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.
- B4 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

Payments in kind

- B5 Some insurance contracts require or permit payments to be made in kind. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.
- B6 Some fixed-fee service contracts in which the level of service depends on an uncertain event meet the definition of an insurance contract in this HKFRS but are not regulated as insurance contracts in some countries. One example is a maintenance

contract in which the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash). Another example is a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage. The latter contract could meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts.

- B7 Applying the HKFRS to the contracts described in paragraph B6 is likely to be no more burdensome than applying the HKFRSs that would be applicable if such contracts were outside the scope of this HKFRS:
- (a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.
 - (b) If ~~HKFRS 15~~~~HKAS 18~~ ~~Revenue~~ applied, the service provider would recognise revenue when (or as) it transfers services to the customer by reference to the stage of completion (and subject to other specified criteria). That approach is also acceptable under this HKFRS, which permits the service provider (i) to continue its existing accounting policies for these contracts unless they involve practices prohibited by paragraph 14 and (ii) to improve its accounting policies if so permitted by paragraphs 22-30.
 - (c) The service provider considers whether the cost of meeting its contractual obligation to provide services exceeds the revenue received in advance. To do this, it applies the liability adequacy test described in paragraphs 15-19 of this HKFRS. If this HKFRS did not apply to these contracts, the service provider would apply HKAS 37 to determine whether the contracts are onerous.
 - (d) For these contracts, the disclosure requirements in this HKFRS are unlikely to add significantly to disclosures required by other HKFRSs.

Distinction between insurance risk and other risks

- B8 The definition of an insurance contract refers to insurance risk, which this HKFRS defines as risk, other than *financial risk*, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.
- B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

- B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.
- B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided the payment that is contingent on the insured event can be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it need not be separated and measured at fair value (see paragraph 7 of this HKFRS).
- B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.
- B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a damaged old asset by a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.
- B14 Some contracts require a payment if a specified uncertain event occurs, but do not require an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses the contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.
- B15 Lapse or persistency risk (ie the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (ie the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

- B16 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the issuer to insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.
- B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract.

Examples of insurance contracts

- B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:
- (a) insurance against theft or damage to property.
 - (b) insurance against product liability, professional liability, civil liability or legal expenses.
 - (c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).
 - (d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).
 - (e) disability and medical cover.
 - (f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).
 - (g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in ~~HKFRS 9~~~~HKAS 39~~ and are within the scope of HKAS 32* and ~~HKFRS 9~~~~HKAS 39~~, not this HKFRS (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either ~~HKAS 39~~~~and HKAS 32~~* and HKFRS 9 or this HKFRS to such financial guarantee contracts.

* When an entity applies HKFRS 7, the reference to HKAS 32 is replaced by a reference to HKFRS 7

- (h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this HKFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of HKFRS 15 ~~HKAS 18~~ and HKAS 37.
- (i) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself.
- (j) travel assistance (ie compensation in cash or in kind to policyholders for losses suffered while they are travelling). Paragraphs B6 and B7 discuss some contracts of this kind.
- (k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).
- (l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.
- (m) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

- (a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, for example life insurance contracts in which the insurer bears no significant mortality risk (such contracts are non-insurance financial instruments or service contracts, see paragraphs B20 and B21).
- (b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts (such contracts are normally non-insurance financial instruments or service contracts, see paragraphs B20 and B21).
- (c) self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party).
- (d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see also paragraph B13).

- (e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see HKFRS 9~~HKAS 39~~).
 - (f) a credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see HKFRS 9~~HKAS 39~~).
 - (g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).
 - (h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.
- B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of HKFRS 9~~HKAS 39~~. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:
- (a) one party recognises the consideration received as a financial liability, rather than as revenue.
 - (b) the other party recognises the consideration paid as a financial asset, rather than as an expense.
- B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, HKFRS 15~~HKAS 18~~ applies. Under HKFRS 15~~HKAS 18~~, revenue associated with a transaction involving the rendering of services is recognised when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer in an amount that reflects the consideration to which the entity expects to be entitled by reference to the stage of completion of the transaction if the outcome of the transaction can be estimated reliably.

Significant insurance risk

- B22 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8-B21 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.
- B23 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (ie probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

- B24 The additional benefits described in paragraph B23 refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:
- (a) the loss of the ability to charge the policyholder for future services. For example, in an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of the client. Therefore, the potential loss of future investment management fees is not relevant in assessing how much insurance risk is transferred by a contract.
 - (b) waiver on death of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, the waiver of these charges does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in assessing how much insurance risk is transferred by a contract.
 - (c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay one million currency units if an asset suffers physical damage causing an insignificant economic loss of one currency unit to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing one currency unit. At the same time, the contract creates non-insurance risk that the issuer will need to pay 999,999 currency units if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.
 - (d) possible reinsurance recoveries. The insurer accounts for these separately.
- B25 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements.* Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.
- B26 It follows from paragraphs B23-B25 that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). As noted in paragraph B24(b), the waiver on death of cancellation or surrender charges is not included in this assessment if this waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.
- B27 Paragraph B23 refers to additional benefits. These additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (in other words, insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder ~~dies~~will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

- B28 If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

Changes in the level of insurance risk

- B29 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the current annuity rates charged by the insurer to other new annuitants when the policyholder exercises the option. The contract transfers no insurance risk to the issuer until the option is exercised, because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.
- B30 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.

Appendix C

Amendments to other HKFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity adopts this HKFRS for an earlier period, these amendments shall be applied for that earlier period.

** * **

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix ~~D~~C

Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared as at July 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKFRS 4.

The International Financial Reporting Standard comparable with HKFRS 4 is IFRS 4 *Insurance Contracts*.

There are no major textual differences between HKFRS 4 and IFRS 4.

*Basis for Conclusions on
Hong Kong Financial Reporting Standards 4*

Insurance Contracts



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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HKFRS 4 is based on IFRS 4 *Insurance Contracts*. In approving HKFRS 4, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 4. Accordingly, there are no significant differences between HKFRS 4 and IFRS 4. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IFRS 4 referred to below generally correspond with those in HKFRS 4.

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Basis for Conclusions on IFRS 4 *Insurance Contracts*

This Basis for Conclusions accompanies, but is not part of, IFRS 4.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 4 *Insurance Contracts*. Individual Board members gave greater weight to some factors than to others.

Background

- BC2 The Board decided to develop an International Financial Reporting Standard (IFRS) on insurance contracts because:
- (a) there was no IFRS on insurance contracts, and insurance contracts were excluded from the scope of existing IFRSs that would otherwise have been relevant (eg IFRSs on provisions, financial instruments, intangible assets).
 - (b) accounting practices for insurance contracts were diverse, and also often differed from practices in other sectors.
- BC3 The Board's predecessor organisation, the International Accounting Standards Committee (IASC), set up a Steering Committee in 1997 to carry out the initial work on this project. In December 1999, the Steering Committee published an *Issues Paper*, which attracted 138 comment letters. The Steering Committee reviewed the comment letters and concluded its work by developing a report to the Board in the form of a *Draft Statement of Principles* (DSOP). The Board started discussing the DSOP in November 2001. The Board did not approve the DSOP or invite formal comments on it, but made it available to the public on the IASB's Website.
- BC4 Few insurers report using IFRSs at present, although many more are expected to do so from 2005. Because it was not feasible to complete this project for implementation in 2005, the Board split the project into two phases so that insurers could implement some aspects in 2005. The Board published its proposals for phase I in July 2003 as ED 5 *Insurance Contracts*. The deadline for comments was 31 October 2003 and the Board received 135 responses. After reviewing the responses, the Board issued IFRS 4 in March 2004.
- BC5 The Board's objectives for phase I were:
- (a) to make limited improvements to accounting practices for insurance contracts, without requiring major changes that may need to be reversed in phase II.
 - (b) to require disclosure that (i) identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and (ii) helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Tentative conclusions for phase II

BC6 The Board sees phase I as a stepping stone to phase II and is committed to completing phase II without delay once it has investigated all relevant conceptual and practical questions and completed its due process. In January 2003, the Board reached the following tentative conclusions for phase II:

- (a) The approach should be an asset-and-liability approach that would require an entity to identify and measure directly the contractual rights and obligations arising from insurance contracts, rather than create deferrals of inflows and outflows.
- (b) Assets and liabilities arising from insurance contracts should be measured at their fair value, with the following two caveats:
 - (i) Recognising the lack of market transactions, an entity may use entity-specific assumptions and information when market-based information is not available without undue cost and effort.
 - (ii) In the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical contractual terms and remaining maturity from new policyholders. It follows that an insurer would not recognise a net gain at inception of an insurance contract, unless such market evidence is available.
- (c) As implied by the definition of fair value: *
 - (i) an undiscounted measure is inconsistent with fair value.
 - (ii) expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).
 - (iii) the measurement of fair value should include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows.
 - (iv) fair value measurement of an insurance contract should reflect the credit characteristics of that contract, including the effect of policyholder protections and insurance provided by governmental bodies or other guarantors.
- (d) The measurement of contractual rights and obligations associated with the closed book of insurance contracts should include future premiums specified in the contracts (and claims, benefits, expenses, and other additional cash flows resulting from those premiums) if, and only if:
 - (i) policyholders hold non-cancellable continuation or renewal rights that significantly constrain the insurer's ability to reprice the contract to rates that would apply for new policyholders whose characteristics are similar to those of the existing policyholders; and

* IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

- (ii) those rights will lapse if the policyholders stop paying premiums.
 - (e) Acquisition costs should be recognised as an expense when incurred.
 - (f) The Board will consider two more questions later in phase II:
 - (i) Should the measurement model unbundle the individual elements of an insurance contract and measure them individually?
 - (ii) How should an insurer measure its liability to holders of participating contracts?
- BC7 In two areas, those tentative conclusions differ from the IASC Steering Committee's recommendations in the DSOP:
- (a) the use of a fair value measurement objective rather than entity-specific value. However, that change is not as significant as it might seem because entity-specific value as described in the DSOP is indistinguishable in most respects from estimates of fair value determined using measurement guidance that the Board has tentatively adopted in phase II of its project on business combinations.*
 - (b) the criteria used to determine whether measurement should reflect future premiums and related cash flows (paragraph BC6(d)).
- BC8 Since January 2003, constraints on Board and staff resources have prevented the Board from continuing work to determine whether its tentative conclusions for phase II can be developed into a standard that is consistent with the IASB *Framework*¹ and workable in practice. The Board intends to return to phase II of the project in the second quarter of 2004. It plans to focus at that time on both conceptual and practical issues, as in any project. Only after completing its deliberations will the Board proceed with an Exposure Draft of a proposed IFRS. The Board's deliberations in all projects include a consideration of alternatives and whether those alternatives represent conceptually superior approaches to financial reporting issues. Consequently, the Board will examine existing practices throughout the world to ascertain whether any could be deemed to be a superior answer suitable for international adoption.
- BC9 As discussed in paragraph BC84, ED 5 proposed a 'sunset clause', which the Board deleted in finalising the IFRS. Although respondents generally opposed the sunset clause, many applauded the Board's signal of its commitment to complete phase II without delay.

Scope

- BC10 Some argued that the IFRS should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They noted that regulatory requirements, and some national accounting requirements, often cover all aspects of an insurer's business. However, for the following reasons,

* The Board completed the second phase of its project on business combinations in 2008 by issuing a revised IFRS 3 *Business Combinations* and an amended version of IAS 27 *Consolidated and Separate Financial Statements*. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

¹ References to the *Framework* are to IASC's *Framework for Preparation and Presentation of Financial Statements*, adopted by IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

the IFRS deals with insurance contracts of all entities and does not address other aspects of accounting by insurers:

- (a) It would be difficult, and perhaps impossible, to create a robust definition of an insurer that could be applied consistently from country to country. Among other things, an increasing number of entities have major activities in both insurance and other areas.
- (b) It would be undesirable for an insurer to account for a transaction in one way and for a non-insurer to account in a different way for the same transaction.
- (c) The project should not reopen issues addressed by other IFRSs, unless specific features of insurance contracts justify a different treatment. Paragraphs BC166-BC180 discuss the treatment of assets backing insurance contracts.

Definition of insurance contract

BC11 The definition of an insurance contract determines which contracts are within the scope of IFRS 4 rather than other IFRSs. Some argued that phase I should use existing national definitions of insurance contracts, on the following grounds:

- (a) Before phase II gives guidance on applying IAS 39 *Financial Instruments: Recognition and Measurement*[#] to difficult areas such as discretionary participation features and cancellation and renewal rights, it would be premature to require insurers to apply IAS 39 to contracts that contain these features and rights.
- (b) The definition adopted for phase I may need to be amended again for phase II. This could compel insurers to make extensive changes twice in a short time.

BC12 However, in the Board's view, it is unsatisfactory to base the definition used in IFRSs on local definitions that may vary from country to country and may not be most relevant for deciding which IFRS ought to apply to a particular type of contract.

BC13 Some expressed concerns that the adoption of a particular definition by the IASB could lead ultimately to inappropriate changes in definitions used for other purposes, such as insurance law, insurance supervision or tax. The Board emphasises that any definition used in IFRSs is solely for financial reporting and is not intended to change or pre-empt definitions used for other purposes.

BC14 Various Standards issued by IASC used definitions or descriptions of insurance contracts to exclude insurance contracts from their scope. The scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and of IAS 38 *Intangible Assets* excluded provisions, contingent liabilities, contingent assets and intangible assets that arise in insurance enterprises from contracts with policyholders. IASC used this wording when its insurance project had just started, to avoid prejudging whether the project would address insurance contracts or a broader class of contracts. Similarly, the scope of IAS 18 *Revenue*^{*} excluded revenue arising from insurance contracts of insurance enterprises.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 also excludes from its scope revenue arising from insurance contracts.

- BC15 The following definition of insurance contracts was used to exclude insurance contracts from the scope of an earlier version of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39.

An insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption.

- BC16 This definition was supplemented by a statement that IAS 32 and IAS 39 did, nevertheless, apply when a financial instrument ‘takes the form of an insurance contract but principally involves the transfer of financial risks.’

- BC17 For the following reasons, the Board discarded the previous definition in IAS 32 and IAS 39:

- (a) The definition gave a list of examples, but did not define the characteristics of the risks that it was intended to include.
- (b) A clearer definition reduces the uncertainty about the meaning of the phrase ‘principally involves the transfer of financial risks’. This will help insurers adopting IFRSs for the first-time (‘first-time adopters’) in 2005 and minimises the likelihood of further changes in classification for phase II. Furthermore, the previous test could have led to many contracts being classified as financial instruments even though they transfer significant insurance risk.

- BC18 In developing a new definition, the Board also considered US GAAP. The main FASB statements for insurers deal with financial reporting by insurance entities and do not define insurance contracts explicitly. However, paragraph 1 of SFAS 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* states:

Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered.

- BC19 Paragraph 6 of SFAS 113 applies to any transaction, regardless of its form, that indemnifies an insurer against loss or liability relating to insurance risk. The glossary appended to SFAS 113 defines insurance risk as:

The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

- BC20 Having reviewed these definitions from US GAAP, the Board developed a new definition of insurance contract for the IFRS and expects to use the same definition for phase II. The following aspects of the definition are discussed below:

- (a) insurance risk (paragraphs BC21-BC24);

- (b) insurable interest (paragraphs BC25-BC29);
- (c) quantity of insurance risk (paragraphs BC30-BC37);
- (d) expiry of insurance-contingent rights and obligations (paragraphs BC38 and BC39);
- (e) unbundling (paragraphs BC40-BC54); and
- (f) weather derivatives (paragraphs BC55-BC60).

Insurance risk

- BC21 The definition of an insurance contract in the IFRS focuses on the feature that causes accounting problems unique to insurance contracts, namely insurance risk. The definition of insurance risk excludes financial risk, defined using a list of risks that also appears in IAS 39's[#] definition of a derivative.
- BC22 Some contracts have the legal form of insurance contracts but do not transfer significant insurance risk to the issuer. Some argue that all such contracts should be treated as insurance contracts, for the following reasons:
- (a) These contracts are traditionally described as insurance contracts and are generally subject to regulation by insurance supervisors.
 - (b) Phase I will not achieve great comparability between insurers because it will permit a diverse range of treatments for insurance contracts. It would be preferable to ensure consistency at least within a single insurer.
 - (c) Accounting for some contracts under IAS 39[#] and others under local GAAP is unhelpful to users. Moreover, some argued that IAS 39 contains insufficient, and possibly inappropriate, guidance for investment contracts.*
 - (d) The guidance proposed in ED 5 on significant insurance risk was too vague, would be applied inconsistently and relied on actuarial resources in short supply in many countries.
- BC23 However, as explained in the *Framework*, financial statements should reflect economic substance and not merely legal form. Furthermore, accounting arbitrage could occur if the addition of an insignificant amount of insurance risk made a significant difference to the accounting. Therefore, the Board decided that contracts described in the previous paragraph should not be treated as insurance contracts for financial reporting.
- BC24 Some respondents suggested that an insurance contract is any contract under which the policyholder exchanges a fixed amount (ie the premium) for an amount payable if an insured event occurs. However, not all insurance contracts have explicit premiums (eg insurance cover bundled with some credit card contracts). Adding a reference to premiums would have introduced no more clarity and might have required more supporting guidance and explanations.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

* 'Investment contract' is an informal term referring to a contract issued by an insurer that does not expose the insurer to significant insurance risk and is therefore within the scope of IAS 39.

Insurable interest

- BC25 In some countries, the legal definition of insurance requires that the policyholder or other beneficiary should have an insurable interest in the insured event. For the following reasons, the definition proposed in 1999 by the former IASC Steering Committee in the Issues Paper did not refer to insurable interest:
- (a) Insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities.
 - (b) Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest.
- BC26 Because the definition proposed in the Issues Paper did not include a notion of insurable interest, it would have encompassed gambling. Several commentators on the Issues Paper stressed the important social, moral, legal and regulatory differences between insurance and gambling. They noted that policyholders buy insurance to reduce risk, whereas gamblers take on risk (unless they use a gambling contract as a hedge). In the light of these comments, the definition of an insurance contract in the IFRS incorporates the notion of insurable interest. Specifically, it refers to the fact that the insurer accepts risk from the policyholder by agreeing to compensate the policyholder if an uncertain event adversely affects the policyholder. The notion of insurable interest also appears in the definition of financial risk, which refers to a non-financial variable not specific to a party to the contract.
- BC27 This reference to an adverse effect is open to the objections set out in paragraph BC25. However, without this reference, the definition of an insurance contract might have captured any prepaid contract to provide services whose cost is uncertain (see paragraphs BC74-BC76 for further discussion). This would have extended the meaning of the term ‘insurance contract’ too far beyond its traditional meaning.
- BC28 Some respondents to ED 5 were opposed to including the notion of insurable interest, on the following grounds:
- (a) In life insurance, there is no direct link between the adverse event and the financial loss to the policyholder. Moreover, it is not clear that survival adversely affects an annuitant. Any contract that is contingent on human life should meet the definition of insurance contract.
 - (b) This notion excludes some contracts that are, in substance, used as insurance, such as weather derivatives (see paragraphs BC55- BC60 for further discussion). The test should be whether there is a reasonable expectation of some indemnification to policyholders. A tradable contract could be brought within the scope of IAS 39.*
 - (c) It would be preferable to eliminate the notion of insurable interest and replace it with the notion that insurance is a business that involves assembling risks into a pool that is managed together.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

BC29 The Board decided to retain the notion of insurable interest because it gives a principle-based distinction, particularly between insurance contracts and other contracts that happen to be used for hedging. Furthermore, it is preferable to base a distinction on the type of contract, rather than the way an entity manages a contract or group of contracts. Moreover, the Board decided that it was unnecessary to refine this notion for a life insurance contract or life-contingent annuity, because such contracts typically provide for a predetermined amount to quantify the adverse effect (see paragraph B13 of the IFRS).

Quantity of insurance risk

BC30 Paragraphs B22-B28 of Appendix B of the IFRS discuss how much insurance risk must be present before a contract qualifies as an insurance contract. In developing this material, the Board noted the conditions in US GAAP for a contract to be treated as an insurance contract. SFAS 113 requires two conditions for a contract to be eligible for reinsurance accounting, rather than deposit accounting:

- (a) the contract transfers significant insurance risk from the cedant to the reinsurer (which does not occur if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote); and
- (b) either:
 - (i) there is a reasonable possibility that the reinsurer will suffer a significant loss (based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes); or
 - (ii) the reinsurer has assumed substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (and the cedant has retained only insignificant insurance risk on the reinsured portions).

BC31 Under paragraph 8 of SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, an annuity contract is considered an insurance contract unless (a) the probability that life contingent payments will be made is remote* or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.

BC32 The Board noted that some practitioners use the following guideline in applying US GAAP: a reasonable possibility of a significant loss is a 10 per cent probability of a 10 per cent loss. In this light, the Board considered whether it should define the amount of insurance risk in quantitative terms in relation to, for example:

- (a) the probability that payments under the contract will exceed the expected (ie probability-weighted average) level of payments; or
- (b) a measure of the range of outcomes, such as the range between the highest and lowest level of payments or the standard deviation of payments.

* Paragraph 8 of SFAS 97 notes that the term remote is defined in paragraph 3 of SFAS 5 *Accounting for Contingencies* as 'the chance of the future event or events occurring is slight.'

- BC33 Quantitative guidance creates an arbitrary dividing line that results in different accounting treatments for similar transactions that fall marginally on different sides of the line. It also creates opportunities for accounting arbitrage by encouraging transactions that fall marginally on one side or the other of the line. For these reasons, the IFRS does not include quantitative guidance.
- BC34 The Board also considered whether it should define the significance of insurance risk by referring to materiality, which the *Framework* describes as follows. ‘Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’ However, a single contract, or even a single book of similar contracts, could rarely generate a loss that is material in relation to the financial statements as a whole. Therefore, the IFRS defines the significance of insurance risk in relation to the individual contract (paragraph B25). The Board had two reasons for this:
- (a) Although insurers manage contracts on a portfolio basis, and often measure them on that basis, the contractual rights and obligations arise from individual contracts.
 - (b) An assessment contract by contract is likely to increase the proportion of contracts that qualify as insurance contracts. If a relatively homogeneous book of contracts is known to consist of contracts that all transfer insurance risk, the Board did not intend to require insurers to examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk (paragraph B25 of the IFRS). The Board intended to make it easier, not harder, for a contract to meet the definition.
- BC35 The Board also rejected the notion of defining the significance of insurance risk by expressing the expected (ie probability-weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This notion had some intuitive appeal because it would consider both amount and probability. However, it would have meant that a contract could start as an investment contract (ie a financial liability) and become an insurance contract as time passes or probabilities are reassessed. In the Board’s view, requiring continuous monitoring over the life of the contract would be too onerous. Instead, the Board adopted an approach that requires this decision to be made once only, at the inception of a contract. The guidance in paragraphs B22-B28 of the IFRS focuses on whether insured events could cause an insurer to pay additional amounts, judged contract by contract.
- BC36 Some respondents objected to ED 5’s proposal that insurance risk would be significant if a single plausible event could cause a loss that is more than trivial. They suggested that such a broad notion of significant insurance risk might permit abuse. Instead, they suggested referring to a reasonable possibility of a significant loss. However, the Board rejected this suggestion because it would have required insurers to monitor the level of insurance risk continually, which could have given rise to frequent reclassifications. It might also have been too difficult to apply this notion to remote catastrophic scenarios; indeed, some respondents asked the Board to clarify whether the assessment should include such scenarios. In finalising the IFRS, the Board clarified the terminology by (a) replacing the notion of a plausible scenario with an explanation of the need to ignore scenarios that have no commercial substance and (b) replacing the term ‘trivial’ with the term ‘insignificant’.

BC37 Some respondents asked the Board to clarify the basis of comparison for the significance test, because of uncertainty about the meaning of the phrase ‘net cash flows arising from the contract’ in ED 5. Some suggested that this would require a comparison with the profit that the issuer expects from the contract. However, the Board had not intended this reading, which would have led to the absurd conclusion that any contract with a profitability of close to zero might qualify as an insurance contract. In finalising the IFRS, the Board confirmed in paragraphs B22-B28 that:

- (a) the comparison is between the amounts payable if an insured event occurs and the amounts payable if no insured event occurs. Implementation Guidance in IG Example 1.3 addresses a contract in which the death benefit in a unit-linked contract is 101 per cent of the unit value.
- (b) surrender charges that might be waived on death are not relevant in assessing how much insurance risk a contract transfers because their waiver does not compensate the policyholder for a pre-existing risk. Implementation Guidance in IG Examples 1.23 and 1.24 is relevant.

Expiry of insurance-contingent rights and obligations

BC38 Some respondents suggested that a contract should no longer be treated as an insurance contract after all insurance-contingent rights and obligations have expired. However, this suggestion could have required insurers to set up new systems to identify these contracts. Therefore, paragraph B30 states that an insurance contract remains an insurance contract until all rights and obligations expire. IG Example 2.19 in the Implementation Guidance addresses dual-trigger contracts.

BC39 Some respondents suggested that a contract should not be regarded as an insurance contract if the insurance-contingent rights and obligations expire after a very short time. The IFRS includes material that may be relevant: paragraph B23 explains the need to ignore scenarios that lack commercial substance and paragraph B24(b) notes that there is no significant transfer of pre-existing risk in some contracts that waive surrender penalties on death.

Unbundling

BC40 The definition of an insurance contract distinguishes insurance contracts within the scope of the IFRS from investments and deposits within the scope of IAS 39.* However, many insurance contracts contain a significant deposit component (ie a component that would, if it were a separate instrument, be within the scope of IAS 39). Indeed, virtually all insurance contracts have an implicit or explicit deposit component, because the policyholder is generally required to pay premiums before the period of risk; therefore, the time value of money is likely to be one factor that insurers consider in pricing contracts.

BC41 To reduce the need for guidance on the definition of an insurance contract, some argue that an insurer should ‘unbundle’ the deposit component from the insurance component. Unbundling has the following consequences:

- (a) The insurance component is measured as an insurance contract.
- (b) The deposit component is measured under IAS 39 at either amortised cost or

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

fair value. This might not be consistent with the basis used for insurance contracts.

- (c) Premium receipts for the deposit component are recognised not as revenue, but rather as changes in the deposit liability. Premium receipts for the insurance element are typically recognised as revenue.
- (d) A portion of the transaction costs incurred at inception is allocated to the deposit component if this allocation has a material effect.

BC42 Supporters of unbundling deposit components argue that:

- (a) an entity should account in the same way for the deposit component of an insurance contract as for an otherwise identical financial instrument that does not transfer significant insurance risk.
- (b) the tendency in some countries for banks to own insurers (and vice versa) and the similarity of products offered by the insurance and fund management sectors suggest that insurers, banks and fund managers should account for the deposit component in a similar manner.
- (c) many groups sell products ranging from pure investments to pure insurance, with all variations in between. Unbundling would avoid sharp discontinuities in the accounting between a product that transfers just enough insurance risk to be an insurance contract, and another product that falls marginally on the other side of the line.
- (d) financial statements should make a clear distinction between premium revenue derived from products that transfer significant insurance risk and premium receipts that are, in substance, investment or deposit receipts.

BC43 The Issues Paper published in 1999 proposed that the deposit component should be unbundled if it is either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. However, commentators on the Issues Paper generally opposed unbundling, giving the following reasons:

- (a) The components are closely interrelated and the value of the bundled product is not necessarily equal to the sum of the individual values of the components.
- (b) Unbundling would require significant and costly systems changes.
- (c) Contracts of this kind are a single product, regulated as insurance business by insurance supervisors and should be treated in a similar way for financial reporting.
- (d) Some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they regard information about gross premium inflows as important. A consistent use of a single measurement basis might be more useful as an aid to economic decisions than mixing one measurement basis for the deposit component with another measurement basis for the insurance component.

BC44 In the light of these arguments, the DSOP proposed that an insurer or policyholder should not unbundle these components. However, that was against the background of

an assumption that the treatments of the two components would be reasonably similar. This may not be the case in phase I, because phase I permits a wide range of accounting treatments for insurance components. Nevertheless, the Board did not wish to require costly changes in phase I that might be reversed in phase II. Therefore, the Board decided to require unbundling only when it is easiest to perform and the effect is likely to be greatest (paragraphs 10-12 of the IFRS and IG Example 3 in the Implementation Guidance).

- BC45 The Board acknowledges that there is no clear conceptual line between the cases when unbundling is required and the cases when unbundling is not required. At one extreme, the Board regards unbundling as appropriate for large customised contracts, such as some financial reinsurance contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations. This may be especially important if a contract was deliberately structured to achieve a specific accounting result. Furthermore, the practical problems cited in paragraph BC43 are much less significant for these contracts.
- BC46 At the other extreme, unbundling the surrender values in a large portfolio of traditional life insurance contracts would require significant systems changes beyond the intended scope of phase I. Furthermore, failing to unbundle these contracts would affect the measurement of these liabilities, but not lead to their complete omission from the insurer's balance sheet. In addition, a desire to achieve a particular accounting result is much less likely to influence the precise structure of these transactions.
- BC47 The option for the policyholder to surrender a traditional life insurance contract at an amount that differs significantly from its carrying amount is an embedded derivative and IAS 39* would require the insurer to separate it and measure it at fair value. That treatment would have the same disadvantages, described in the previous paragraph, as unbundling the surrender value. Therefore, paragraph 8 of the IFRS exempts an insurer from applying this requirement to some surrender options embedded in insurance contracts. However, the Board saw no conceptual or practical reason to create such an exemption for surrender options in non-insurance financial instruments issued by insurers or by others.
- BC48 Some respondents opposed unbundling in phase I on the following grounds, in addition to the reasons given in paragraph BC43:
- (a) Insurance contracts are, in general, designed, priced and managed as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. In consequence, any unbundling required solely for accounting would be artificial. Insurance contracts should not be unbundled unless the structure of the contract is clearly artificial.
 - (b) Unbundling may require extensive systems changes that would increase the administrative burden for 2005 and not be needed for phase II.
 - (c) There would be no need to require unbundling if the Board strengthened the liability adequacy test, defined significant insurance risk more narrowly and confirmed that contracts combined artificially are separate contracts.

* The Board amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This basis for conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

- (d) The unbundling conditions in ED 5 were vague and did not explain the underlying principle.
- (e) Because ED 5 did not propose recognition criteria, insurers would use local GAAP to judge whether assets and liabilities were omitted. This would defeat the stated reason for unbundling.
- (f) If a contract is unbundled, the premium for the deposit component is recognised not as premium revenue but as a balance sheet movement (ie as a deposit receipt). Requiring this would be premature before the Board completes its project on reporting comprehensive income.

BC49 Some suggested other criteria for unbundling:

- (a) All contracts should be unbundled, or unbundling should always be permitted at least. Unbundling is required in Australia and New Zealand.
- (b) All non-insurance components (for example, service components) should be unbundled, not only deposit components.
- (c) Unbundling should be required only when the components are completely separable, or when there is an account in the name of the policyholder.
- (d) Unbundling could affect the presentation of revenue more than it affects liability recognition. Therefore, unbundling should also be required if it would have a significant effect on reported revenue and is easy to perform.

BC50 Some respondents argued that the test for unbundling should be two-sided (ie the cash flows of the insurance component and the investment component do not interact) rather than the one-sided test proposed in ED 5 (ie the cash flows from the insurance component do not affect the cash flows from the deposit component). Here is an example where this might make a difference: in some life insurance contracts, the death benefit is the difference between (a) a fixed amount and (b) the value of a deposit component (for example, a unit-linked investment). The deposit component can be measured independently, but the death benefit depends on the unit value so the insurance component cannot be measured independently.

BC51 The Board decided that phase I should not require insurers to set up systems to unbundle the products described in the previous paragraph. However, the Board decided to rely on the condition that provides an exemption from unbundling if all the rights and obligations under the deposit component are recognised. If this condition is not met, unbundling is appropriate.

BC52 Some argued that it is irrelevant whether the insurance component affects the deposit component. They suggested that a deposit component exists if the policyholder will receive a minimum fixed amount of future cash flows in the form of either a return of premium (if no insured event occurs) or an insurance recovery (if an insured event occurs). However, the Board noted that this focus on a single cash flow would not result in unbundling if a financial instrument and an insurance contract are combined artificially into a single contract and the cash flows from one component offset cash flows from the other component. The Board regarded that result as inappropriate and open to abuse.

- BC53 In summary, the Board retained the approach broadly as in ED 5. This requires unbundling if that is needed to ensure the recognition of rights and obligations arising from the deposit component and those rights and obligations can be measured separately. If only the second of these conditions is met, the IFRS permits unbundling, but does not require it.
- BC54 Some respondents suggested that if a contract has been artificially separated through the use of side letters, the separate components of the contract should be considered together. The Board did not address this because it is a wider issue for the Board's possible future work on linkage (ie accounting for separate transactions that are connected in some way). The footnote to paragraph B25 refers to simultaneous contracts with the same counterparty.

Weather derivatives

- BC55 The scope of IAS 39* previously excluded contracts that require a payment based on climatic, geological, or other physical variables (if based on climatic variables, sometimes described as weather derivatives). It is convenient to divide these contracts into two categories:
- (a) contracts that require a payment only if a particular level of the underlying climatic, geological, or other physical variables adversely affects the contract holder. These are insurance contracts as defined in the IFRS.
 - (b) contracts that require a payment based on a specified level of the underlying variable regardless of whether there is an adverse effect on the contract holder. These are derivatives and the IFRS removes a previous scope exclusion to bring them within the scope of IAS 39.
- BC56 The previous scope exclusion was created mainly because the holder might use such a derivative in a way that resembles the use of an insurance contract. However, the definition of an insurance contract in the IFRS now provides a principled basis for deciding which of these contracts are treated as insurance contracts and which are treated as derivatives. Therefore, the Board removed the scope exclusion from IAS 39 (see paragraph C3 of Appendix C of the IFRS). Such contracts are within the scope of the IFRS if payment is contingent on changes in a physical variable that is specific to a party to the contract, and within the scope of IAS 39 in all other cases.
- BC57 Some respondents suggested that a weather derivative should be treated as:
- (a) an insurance contract if it is expected to be highly effective in mitigating an existing risk exposure.
 - (b) a derivative financial instrument otherwise.
- BC58 Some argued that some weather derivatives are, in substance, insurance contracts. For example, under some contracts, the policyholder can claim a fixed sum based on rainfall levels at the nearest weather station. The contract was purchased to provide insurance against low rainfall but was structured like this because of difficulties in measuring actual loss suffered and because of the moral hazard of having a rainfall gauge on the policyholder's property. It can reasonably be expected that the rainfall at the nearest weather station will affect the holder, but the physical variable specified in

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

the contract (ie rainfall) is not specific to a party to the contract. Similarly, some insurers use weather derivatives as a hedge against insurance contracts they issue and view them as similar to reinsurance.

- BC59 Some suggested that weather derivatives should be excluded from the scope of the IFRS because they are tradable instruments that behave like other derivatives and have an observable market value, rather than because there is no contractual link between the holder and the event that triggers payment.
- BC60 The IFRS distinguishes an insurance contract (in which an adverse effect on the policyholder is a contractual precondition for payment) from other instruments, such as derivatives and weather derivatives (in which an adverse effect is not a contractual precondition for payment, although the counterparty may, in fact, use the instrument to hedge an existing exposure). In the Board's view, this is an important and useful distinction. It is much easier to base a classification on the terms of the contract than on an assessment of the counterparty's motive (ie hedging or trading). Consequently, the Board made no change to ED 5's proposals for the treatment of weather derivatives.

Scope exclusions

- BC61 The scope of the IFRS excludes various items that may meet the definition of insurance contracts, but are, or will be, covered by existing or proposed future IFRSs (paragraph 4). The following paragraphs discuss:
- (a) financial guarantees and insurance against credit risk (paragraphs BC62-BC68);
 - (b) product warranties (paragraphs BC69-BC72);
 - (c) accounting by policyholders (paragraph BC73); and
 - (d) prepaid service contracts (paragraphs BC74-BC76).

Financial guarantees and insurance against credit risk

- BC62 The Basis for Conclusions on IAS 39* explains the reasons for the Board's conclusions on financial guarantee contracts.
- BC63-
BC68 [Deleted]

Product warranties

- BC69 A product warranty clearly meets the definition of an insurance contract if an entity issues it on behalf of another party (such as a manufacturer, dealer or retailer). The scope of the IFRS includes such warranties.
- BC70 A product warranty issued directly by a manufacturer, dealer or retailer also meets the definition of an insurance contract. Although some might think of this as 'self-insurance', the risk retained arises from existing contractual obligations towards the customer. Some may reason that the definition of insurance contracts should exclude such direct warranties because they do not involve a transfer of risk from buyer to seller, but rather a crystallisation of an existing responsibility. However, in

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

the Board's view, excluding these warranties from the definition of insurance contracts would complicate the definition for only marginal benefit.

- BC71 Although such direct warranties create economic exposures similar to warranties issued on behalf of the manufacturer, dealer or retailer by another party (ie the insurer), the scope of the IFRS excludes them because they are closely related to the underlying sale of goods and because IAS 37 addresses product warranties. IAS 18* deals with the revenue received for such warranties.
- BC72 In a separate project, the Board is exploring an asset and liability approach to revenue recognition. If this approach is implemented, the accounting model for these direct product warranties may change.[#]

Accounting by policyholders

- BC73 The IFRS does not address accounting and disclosure by policyholders for direct insurance contracts because the Board does not regard this as a high priority for phase I. The Board intends to address accounting by policyholders in phase II (see IASB *Update* February 2002 for the Board's discussion of accounting by policyholders). IFRSs address some aspects of accounting by policyholders for insurance contracts:
- (a) IAS 37 addresses accounting for reimbursements from insurers for expenditure required to settle a provision.
 - (b) IAS 16 addresses some aspects of compensation from third parties for property, plant and equipment that was impaired, lost or given up.
 - (c) Because policyholder accounting is outside the scope of the IFRS, the hierarchy of criteria in paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies to policyholder accounting (see paragraphs BC77-BC86).
 - (d) A policyholder's rights and obligations under insurance contracts are outside the scope of IAS 32 and IAS 39.[∇]

Prepaid service contracts

- BC74 Some respondents noted that the definition proposed in ED 5 captured some prepaid contracts to provide services whose cost is uncertain. Because these contracts are not normally regarded as insurance contracts, these respondents suggested that the Board should change the definition or exclude these contracts from the scope of the IFRS. Respondents cited two specific examples.
- (a) Fixed fee service contracts if the level of service depends on an uncertain event, for example maintenance contracts if the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, although it is uncertain that the machines will actually break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind,

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.

IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and completed the Board's Revenue Recognition project.

∇ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

rather than cash).

- (b) Some car breakdown assistance if (i) each breakdown has little incremental cost because employed patrols provide most of the assistance, (ii) the motorist pays for all parts and repairs, (iii) the service provider's only responsibility is to take the car to a specified destination (eg the nearest garage, home or the original destination), (iv) the need to provide assistance (and the related cost) is known within hours and (v) the number of call-outs is limited.

BC75 The Board saw no conceptual reason to change either the definition of insurance contracts or the scope of the IFRS in the light of the two examples cited by respondents. Paragraphs B6 and B7 of the IFRS note that complying with the IFRS in phase I is unlikely to be particularly burdensome in these two examples, for materiality reasons. The Board may need to review this conclusion in phase II.

BC76 Some respondents argued that the proposals in ED 5 were directed primarily at entities that are generally regarded as insurers. They suggested that the Board should not impose these proposals on entities that have a relatively small amount of a given transaction type. The Board concluded that these comments were primarily about materiality. IAS 1 *Presentation of Financial Statements* and IAS 8 address materiality and the Board decided that no further guidance or specific exemption was needed in this case.

Temporary exemption from some other IFRSs

BC77 Paragraphs 10-12 of IAS 8 specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Without changes made in the IFRS, an insurer adopting IFRSs in 2005 would have needed to assess whether its accounting policies for insurance contracts comply with these requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some insurers might have made major changes in 2005 followed by further significant changes in phase II.

BC78 To avoid unnecessary disruption for both users and preparers in phase I that would not have eased the transition to phase II, the Board decided to limit the need for insurers to change their existing accounting policies for insurance contracts. The Board did this by the following measures:

- (a) creating a temporary exemption from the hierarchy in IAS 8 that specifies the criteria an entity uses in developing an accounting policy if no IFRS applies specifically to an item. The exemption applies to insurers, but not to policyholders.
- (b) limiting the impact of that exemption from the hierarchy by five specific requirements (relating to catastrophe provisions, liability adequacy, derecognition, offsetting and impairment of reinsurance assets, see paragraphs BC87-BC114).
- (c) permitting some existing practices to continue but prohibiting their introduction (paragraphs BC123-BC146).

- BC79 Some respondents opposed the exemption from the hierarchy on the grounds that it would permit too much diversity and allow fundamental departures from the *Framework* that could prevent an insurer's financial statements from presenting information that is understandable, relevant, reliable and comparable. The Board did not grant the exemption from the hierarchy in IAS 8 lightly, but took this unusual step to minimise disruption in 2005 for both users (eg lack of continuity of trend data) and preparers (eg systems changes).
- BC80 ED 6 *Exploration for and Evaluation of Mineral Resources* proposes a temporary exemption from paragraphs 11 and 12 of IAS 8 (ie sources of guidance), but not from paragraph 10 (ie relevance and reliability). That proposed exemption is narrower than in IFRS 4 because ED 6 leaves a relatively narrow range of issues unaddressed. In contrast, because IFRS 4 leaves many significant aspects of accounting for insurance contracts until phase II, a requirement to apply paragraph 10 of IAS 8 to insurance contracts would have had much more pervasive effects and insurers would have needed to address matters such as completeness, substance over form and neutrality.
- BC81 Some suggested that the Board should specifically require an insurer to follow its national accounting requirements (national GAAP) in accounting for insurance contracts during phase I, to prevent selection of accounting policies that do not form a comprehensive basis of accounting to achieve a predetermined result ('cherry-picking'). However, defining national GAAP would have posed problems. Further definitional problems could have arisen because some insurers do not apply the national GAAP of their own country. For example, some non-US insurers with a US listing apply US GAAP. Moreover, it is unusual and, arguably, beyond the Board's mandate to impose requirements set by another body.
- BC82 In addition, an insurer might wish to improve its accounting policies to reflect other accounting developments with no counterpart in national GAAP. For example, an insurer adopting IFRSs for the first time might wish to amend its accounting policies for insurance contracts for greater consistency with accounting policies that it uses for contracts within the scope of IAS 39.* Similarly, an insurer might wish to improve its accounting for embedded options and guarantees by addressing both their time value and their intrinsic value, even if no similar improvements are made to its national GAAP.
- BC83 Therefore, the Board decided that an insurer could continue to follow the accounting policies that it was using when it first applied the phase I requirements, with some exceptions noted below. An insurer could also improve those accounting policies if specified criteria are met (see paragraphs 21-30 of the IFRS).
- BC84 The criteria in paragraphs 10-12 of IAS 8 include relevance and reliability. Granting an exemption from those criteria, even temporarily, is a highly unusual step. The Board was prepared to contemplate that step only as part of an orderly and relatively fast transition to phase II. Because the exemption is so exceptional, ED 5 proposed that it would apply only for accounting periods beginning before 1 January 2007. Some described this time limit as a 'sunset clause'.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

BC85 Many respondents opposed the sunset clause. They argued the following:

- (a) If the exemption expired in 2007 before phase II is in force, there would be considerable confusion, disruption and cost for both users and preparers. It would not be appropriate to penalise users and preparers if the Board does not complete phase II on time.
- (b) The sunset clause might be perceived as putting pressure on the Board to complete phase II without adequate consultation, investigation and testing.

The Board accepted the validity of these objections to the sunset clause and deleted it.

BC86 The Board decided to maintain some requirements that follow from the criteria in IAS 8. The Board acknowledges that it is difficult to make piecemeal changes to recognition and measurement practices in phase I because many aspects of accounting for insurance contracts are interrelated with aspects that will not be completed until phase II. However, abandoning these particular requirements would detract from the relevance and reliability of an insurer's financial statements to an unacceptable degree. Moreover, these requirements are not interrelated to a great extent with other aspects of recognition and measurement and the Board does not expect phase II to reverse these requirements. The following points are discussed below:

- (a) catastrophe and equalisation provisions (paragraphs BC87-BC93)
- (b) liability adequacy (paragraphs BC94-BC104)
- (c) derecognition (paragraph BC105)
- (d) offsetting (paragraph BC106)
- (e) impairment of reinsurance assets (paragraphs BC107-BC114).

Catastrophe and equalisation provisions

BC87 Some insurance contracts expose the insurer to infrequent but severe catastrophic losses caused by events such as damage to nuclear installations or satellites or earthquake damage. Some jurisdictions permit or require catastrophe provisions for contracts of this type. The catastrophe provisions are generally built up gradually over the years out of the premiums received, usually following a prescribed formula, until a specified limit is reached. They are intended to be used on the occurrence of a future catastrophic loss that is covered by current or future contracts of this type. Some countries also permit or require equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims for some types of insurance contract (eg hail, credit, guarantee and fidelity insurance) using a formula based on experience over a number of years.

BC88 Those who favour recognising catastrophe or equalisation provisions as liabilities base their view on one or more of the following arguments:

- (a) Such provisions represent a deferral of unearned premiums that are designed to provide for events that are not expected, on average, to occur in any single contract period but are expected to occur over an entire cycle of several contract periods. Although contracts cover only one period in form, in

substance contracts are commonly renewed, leading to pooling of risks over time rather than within a single period. Indeed, some jurisdictions make it difficult for an insurer to stop offering insurance against some forms of risk, such as hurricanes.

- (b) In some jurisdictions, an insurer is required to segregate part of the premium (the catastrophe premium). The catastrophe premium is not available for distribution to shareholders (except on liquidation) and, if the insurer transfers the contract to another insurer, it must also transfer the catastrophe premium.
- (c) In years when no catastrophe occurs (or when claims are abnormally low), such provisions portray an insurer's long-term profitability faithfully because they match the insurer's costs and revenue over the long term. Also, they show a pattern of profit similar to one obtained through reinsurance, but with less cost and administrative burden.
- (d) Such provisions enhance solvency protection by restricting the amounts distributed to shareholders and by restricting a weak company's ability to expand or enter new markets.
- (e) Such provisions encourage insurers to accept risks that they might otherwise decline. Some countries reinforce this encouragement with tax deductions.

BC89 For the following reasons, the IFRS prohibits the recognition as a liability of provisions for possible future claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions):

- (a) Such provisions are not liabilities as defined in the *Framework*, because the insurer has no present obligation for losses that will occur after the end of the current contract period. As the *Framework* states, the matching concept does not allow the recognition of items in the balance sheet that do not meet the definition of assets or liabilities. Recognising deferred credits as if they were liabilities would diminish the relevance and reliability of an insurer's financial statements.
- (b) Even if the insurance law requires an insurer to segregate catastrophe premiums so that they are not available for distribution to shareholders in any circumstances, earnings on those segregated premiums will ultimately be available to shareholders. Therefore, those segregated amounts are appropriately classified as equity, not as a liability.
- (c) Recognising such provisions obscures users' ability to examine the impact of past catastrophes and does not contribute to their analysis of an insurer's exposure to future catastrophes. Given adequate disclosure, knowledgeable users understand that some types of insurance expose an insurer to infrequent but severe losses. Moreover, the analogy with reinsurance contracts is irrelevant, because reinsurance actually changes the insurer's risk profile.
- (d) The objective of general purpose financial statements is not to enhance solvency but to provide information that is useful to a wide range of users for economic decisions. Moreover, the recognition of provisions does not, by itself, enhance solvency. However, if the objective of financial statements were to enhance solvency and such provisions were an appropriate means of enhancing solvency, it would follow that the insurer should recognise the

entire provision immediately, rather than accumulating it over time. Furthermore, if catastrophes (or unusual experience) in one period are independent of those in other periods, the insurer should not reduce the liability when a catastrophe (or unusually bad experience) occurs. Also, if diversification over time were a valid basis for accounting, above-average losses in early years should be recognised as assets, yet proponents of catastrophe and equalisation provisions do not advocate this.

- (e) Recognising catastrophe or equalisation provisions is not the only way to limit distributions to shareholders. Other measures, such as solvency margin requirements and risk-based capital requirements, could play an important role. Another possibility is for an insurer to segregate a portion of its equity for retention to meet possible losses in future years.
- (f) The objective of general purpose financial statements is not to encourage or discourage particular transactions or activities, but to report neutral information about transactions and activities. Therefore, accounting requirements should not try to encourage insurers to accept or decline particular types of risks.
- (g) If an insurer expects to continue writing catastrophe cover, presumably it believes that the future business will be profitable. It would not be representationally faithful to recognise a liability for future contracts that are expected to be profitable.
- (h) There is no objective way to measure catastrophe and equalisation provisions, unless an arbitrary formula is used.

BC90 Some suggested that it is not appropriate to eliminate catastrophe and equalisation provisions in phase I as a piecemeal amendment to existing approaches. However, the Board concluded that it could prohibit these provisions without undermining other components of existing approaches. There is no credible basis for arguing that catastrophe or equalisation ‘provisions’ are recognisable liabilities under IFRSs and there is no realistic prospect that the Board will permit them in phase II. Indeed, as noted above, paragraphs 10-12 of IAS 8 require an entity to consider various criteria in developing an accounting policy for an item if no IFRS applies specifically to that item. In the Board’s view, if the IFRS had not suspended that requirement, it would clearly have prohibited the recognition of such items as a liability. Accordingly, the IFRS preserves this prohibition (see paragraph 14(a) of the IFRS).

BC91 Some respondents presented additional arguments for permitting the recognition of catastrophe and equalisation provisions as a liability:

- (a) Some insurers measure insurance contracts without margins for risk, but instead recognise catastrophe or equalisation provisions. If catastrophe provisions are eliminated in phase I, this change might be partly reversed in phase II if insurers are then required to include margins for risk.
- (b) Some insurers regard these provisions as relating partly to existing contracts and partly to future contracts. Splitting these components may be difficult and involve systems changes that might not be needed in phase II.

BC92 For the following reasons, these arguments did not persuade the Board:

- (a) Present imperfections in the measurement of recognisable liabilities do not justify the recognition of other items that do not meet the definition of a liability.
- (b) Additions to these provisions are often based on a percentage of premium revenue. If the risk period has already expired, that premium does not relate to an existing contractual obligation. If the risk period has not yet fully expired, the related portion of the premium relates to an existing contractual obligation, but most existing models defer all the related premium as unearned premium, so recognising an additional provision would be double-counting (unless the contract were known to be underpriced).

BC93 Accordingly, the Board retained the proposal in ED 5 to eliminate these provisions. However, although the IFRS prohibits their recognition as a liability, it does not prohibit the segregation of a component of equity. Changes in a component of equity are not recognised in profit or loss. IAS 1 requires a statement of changes in equity.

Liability adequacy

BC94 Many existing accounting models have tests to confirm that insurance liabilities are not understated, and that related amounts recognised as assets, such as deferred acquisition costs, are not overstated. The precise form of the test depends on the underlying measurement approach. However, there is no guarantee that these tests exist everywhere and the credibility of IFRSs could suffer if an insurer claims to comply with IFRSs but fails to recognise material and reasonably foreseeable losses arising from existing contractual obligations. To avoid this, the IFRS requires a liability adequacy test* (see paragraphs 15-19).

BC95 The Board's intention was not to introduce piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses remain unrecognised during phase I. With this in mind, paragraph 16 of the IFRS defines minimum requirements that an insurer's existing test must meet. If the insurer does not apply a test that meets those requirements, it must apply a test specified by the Board. To specify a test on a basis that already exists in IFRSs and minimise the need for exceptions to existing principles, the Board decided to draw on IAS 37.

BC96 The liability adequacy test also applies to deferred acquisition costs and to intangible assets representing the contractual rights acquired in a business combination or portfolio transfer. As a result, when the Board revised IAS 36 *Impairment of Assets* in 2004, it excluded deferred acquisition costs and those intangible assets from the scope of IAS 36.

BC97 The Board considered whether it should retain the impairment model in IAS 36 for deferred acquisition costs, and perhaps also the related insurance liabilities. However, the IAS 36 model cannot be applied to deferred acquisition costs alone, without also considering the cash flows relating to the recognised liability. Indeed, some insurers capitalise acquisition costs implicitly through deductions in the measurement of the liability. Moreover, it would be confusing and difficult to apply this model to liabilities without some re-engineering. In the Board's view, it is simpler to use a

* ED 5 described this as a 'loss recognition test'

model that is designed for liabilities, namely the IAS 37 model. In practice, a re-engineered IAS 36 model and IAS 37 might not lead to very different results.

- BC98 Some respondents suggested that the Board should specify that the cash flows considered in a liability adequacy test should include the effect of embedded options and guarantees, such as guaranteed annuity rates. They expressed concerns that many national practices have not required insurers to recognise these exposures, which can be very large.
- BC99 Although the Board's objective was not to develop a detailed liability adequacy test, it observed that the size of exposures to embedded guarantees and options and the failings of many national practices in this area warranted specific requirements, even in phase I. Accordingly, the Board decided that the minimum requirements for an existing liability-adequacy test should include considering cash flows resulting from embedded options and guarantees. The Board did not specify how those cash flows should be considered but noted that an insurer would consider this matter in developing disclosures of its accounting policies. If an existing liability adequacy test does not meet the minimum requirements, a comparison is made with the measurement that IAS 37 would require. IAS 37 refers to the amount that an entity would rationally pay to settle the obligation or transfer it to a third party. Implicitly, this amount would consider the possible effect of embedded options and guarantees.
- BC100 ED 5 did not specify the level of aggregation for the liability adequacy test and some respondents asked the Board to clarify this. Paragraph 18 of the IFRS confirms that the aggregation requirements of the existing liability adequacy test apply if the test meets the minimum requirements specified in paragraph 16 of the IFRS. If that test does not meet those minimum requirements, there is no conceptual justification for offsetting a loss on one contract against an otherwise unrecognisable gain on another contract. However, the Board concluded that a contract-by-contract assessment would impose costs that exceed the likely benefits to users. Therefore, paragraph 18 states that the comparison is made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a portfolio. More precise definition would be difficult and is not needed, given the Board's restricted objective of ensuring at least a minimum level of testing for the limited life of phase I.
- BC101 It is beyond the scope of phase I to create a detailed accounting regime for insurance contracts. Therefore, the IFRS does not specify:
- (a) what criteria determine when existing contracts end and future contracts start.
 - (b) whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty.
 - (c) whether the liability adequacy test considers both the time value and the intrinsic value of embedded options and guarantees.
 - (d) whether additional losses recognised because of the liability adequacy test are recognised by reducing the carrying amount of deferred acquisition costs or by increasing the carrying amount of the related insurance liabilities.
- BC102 Some respondents asked the Board to clarify that no formal liability adequacy test is needed if an entity can demonstrate that its method of measuring insurance liabilities means that they are not understated. Paragraph 15 of the IFRS requires an insurer to 'assess whether its recognised insurance liabilities are adequate, using current estimates of future cash flows'. The fundamental point is that future cash flows must

be considered in some way, and not merely be assumed to support the existing carrying amount. The IFRS does not specify the precise means of ensuring this, as long as the minimum requirements in paragraph 16 are met.

BC103 Some respondents read the liability adequacy test proposed in ED 5 as requiring fair value measurement as a minimum. That was not the Board's intention. An insurer needs to refer to IAS 37 only if the minimum requirements in paragraph 16 are not met.

BC104 Some respondents noted that many existing liability adequacy tests require measurements that do not include a risk margin. However, IAS 37 requires such a margin. To achieve consistency, these respondents suggested that a liability adequacy test under IAS 37 should also exclude these margins. The Board did not adopt this suggestion. The idea behind using IAS 37 for phase I was to take an existing measurement basis 'off the shelf' rather than create a new model.

Derecognition

BC105 The Board identified no reasons why derecognition requirements for insurance liabilities and insurance assets should differ from those for financial liabilities and financial assets. Therefore, the derecognition requirements for insurance liabilities are the same as for financial liabilities (see paragraph 14(c) of the IFRS). However, because derecognition of financial assets is a controversial topic, the IFRS does not address derecognition of insurance assets.

Offsetting

BC106 A cedant (ie the insurer that is the policyholder under a reinsurance contract) does not normally have a right to offset amounts due from a reinsurer against amounts due to the underlying policyholder. Normal offsetting criteria prohibit offsetting when no such right exists. When these criteria are not met, a gross presentation gives a clearer picture of the cedant's rights and obligations, and related income and expense (see paragraph 14(d) of the IFRS).

Reinsurance assets

Impairment of reinsurance assets

BC107 ED 5 proposed that a cedant should apply IAS 36 *Impairment of Assets* to its reinsurance assets. Respondents opposed this proposal for the following reasons:

- (a) This would compel many cedants to change their accounting model for reinsurance contracts in a way that is inconsistent with the accounting for the underlying direct insurance liability.
- (b) IAS 36 would require the cedant to address matters that are beyond the scope of phase I for the underlying direct insurance liability, such as the cash flows to be discounted, the discount rate and the approach to risk. Some saw IAS 36 as an indirect way of imposing something similar to a fair value model. There would also have been systems implications.

- (c) Reinsurance assets are essentially a form of financial asset and should be subject, for impairment testing, to IAS 39* rather than IAS 36.

BC108 The Board concluded that an impairment test for phase I (a) should focus on credit risk (arising from the risk of default by the reinsurer and also from disputes over coverage) and (b) should not address matters arising from the measurement of the underlying direct insurance liability. The Board decided that the most appropriate way to achieve this was an incurred loss model based on that in IAS 39 (see paragraph 20 of the IFRS).

Gains and losses on buying reinsurance

BC109 The IFRS defines a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant. One consequence is that the level of insurance risk required to meet the definition of an insurance contract is the same for a reinsurance contract as for a direct insurance contract.

BC110 National accounting requirements often define reinsurance contracts more strictly than direct insurance contracts to avoid distortion through contracts that have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). One source of such distortions is the failure to discount many non-life insurance claims liabilities. If the insurer buys reinsurance, the premium paid to the reinsurer reflects the present value of the liability and is, therefore, less than the previous carrying amount of the liability. Reporting a gain on buying the reinsurance is not representationally faithful if no economic gain occurred at that time. The accounting gain arises largely because of the failure to use discounting for the underlying liability. Similar problems arise if the underlying insurance liability is measured with excessive prudence.

BC111 The Board decided that it would not use the definition of a reinsurance contract to address these problems because the Board found no conceptual reason to define a reinsurance contract more or less strictly than a direct insurance contract. Instead, ED 5 addressed these problems through the following proposals:

- (a) prohibiting derecognition if the liability is not extinguished (paragraphs 14(c) of the IFRS and BC105) and prohibiting the offsetting of reinsurance assets against the related direct insurance liabilities (paragraphs 14(d) of the IFRS and BC106).
- (b) requiring unbundling in some cases (paragraphs 10-12 of the IFRS, IG Example 3 in the Implementation Guidance and paragraphs BC40-BC54).
- (c) limiting the recognition of gains when an insurer buys reinsurance.

BC112 Respondents to ED 5 generally opposed the proposal described in paragraph BC111(c), on the following grounds:

- (a) These piecemeal amendments to existing accounting models were beyond the scope of phase I and would require new systems that might not be needed in phase II.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (b) The proposals would have been difficult to apply to more complex reinsurance contracts, including excess of loss contracts and contracts that reinsure different layers of a portfolio of underlying direct insurance contracts.
- (c) The proposals would have created inconsistencies with the measurement of the underlying direct insurance contracts.
- (d) The artificial gain recognised at inception of some reinsurance contracts mitigates an artificial loss that arose earlier from excessive prudence or lack of discounting. If the net exposure has been reduced by reinsurance, there is no reason to continue to overstate the original liability.
- (e) Any deferral of profit on buying reinsurance should be recognised as a liability, not as a reduction in the carrying amount of the reinsurance asset. This would permit assets and liabilities relating to the same underlying insurance contracts to be measured on a consistent basis and would also be consistent with other accounting bases such as US GAAP.
- (f) Any restrictions in phase I should be targeted more precisely at financial reinsurance transactions (ie transactions that do not meet the definition of an insurance contract or that have significant financial components) or contracts that provide retroactive cover (ie ones that cover events that have already occurred).
- (g) The liability adequacy test and unbundling proposals would have provided sufficient safeguards against the recognition of excessive profits.

BC113 The Board considered limiting the proposed requirements to cases where significant distortions in reported profit were most likely to occur, for example retroactive contracts. However, developing such a distinction would have been time-consuming and difficult, and there would have been no guarantee of success. The Board also considered drawing on requirements in US GAAP but decided not to include detailed requirements of this kind as a temporary and only partly effective solution. The proposals in ED 5 were an attempt to develop a simpler temporary solution. The responses indicated that the proposed solution contained too many imperfections to achieve its purpose.

BC114 The Board decided to delete the proposal in ED 5 and replace it with a specific disclosure requirement for gains and losses that arose on buying reinsurance (see paragraph 37(b) of the IFRS).

Other existing practices

BC115 The IFRS does not address:

- (a) acquisition costs (paragraphs BC116-BC119);
- (b) salvage and subrogation (paragraphs BC120 and BC121); and
- (c) policy loans (paragraph BC122).

Acquisition costs

BC116 Acquisition costs are the costs that an insurer incurs to sell, underwrite and initiate a new insurance contract. The IFRS neither prohibits nor requires the deferral of acquisition costs, nor does it prescribe what acquisition costs are deferrable, the period and method of their amortisation or whether an insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. The treatment of deferred acquisition costs is an integral part of existing models and cannot be amended easily without a more fundamental review of those models in phase II.

BC117 The treatment of acquisition costs for insurance contracts in phase I may differ from the treatment of transaction costs incurred for investment contracts (ie financial liabilities). IAS 39^{*} requires specified transaction costs to be presented as a deduction in determining the initial carrying amount of a financial liability. The Board did not wish to create exceptions to the definition of the transaction costs to which this treatment applies. Those costs may be defined more broadly or more narrowly than the acquisition costs that an insurer is required or permitted to defer using its existing accounting policies.

BC118 Some entities incur significant costs in originating long-term savings contracts. Some respondents argued that most, if not all, of these costs relate to the right to charge future investment management fees rather than to the financial liability that is created when the first instalment is received. They asked the Board to clarify whether the cost of originating those rights could be recognised as a separate asset rather than as a deduction in determining the initial carrying amount of the financial liability. They noted that this treatment would:

- (a) simplify the application of the effective interest method for a financial liability carried at amortised cost.
- (b) prevent the recognition of a misleading loss at inception for a financial liability that contains a demand feature and is carried at fair value. IAS 39 states that the fair value of such a liability is not less than the amount payable on demand (discounted, if applicable, from the first date when that amount could be required to be paid).

BC119 In response to these comments, the Board decided that incremental costs directly attributable to securing an investment management contract should be recognised as an asset if they meet specified criteria, and that incremental costs should be defined in the same way as in IAS 39. The Board clarified these points by adding guidance to illustrative examples accompanying the appendix of IAS 18 Revenue.[#]

Salvage and subrogation

BC120 Some insurance contracts permit the insurer to sell (usually damaged) property acquired in settling the claim (ie salvage). The insurer may also have the right to pursue third parties for payment of some or all costs (ie subrogation). The Board will consider salvage and subrogation in phase II.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. The guidance on the accounting for incremental costs directly attributable to securing an investment management contract was replaced by requirements in IFRS 15.

BC121 In the following two related areas, the IFRS does not amend IAS 37:

- (a) Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the IFRS dealing with the assets concerned (paragraphs 51 and 52 of IAS 37).
- (b) Paragraphs 53-58 of IAS 37 address reimbursements for some or all of the expenditure required to settle a provision.

The Board is working on a project to amend various aspects of IAS 37.

Policy loans

BC122 Some insurance contracts permit the policyholder to obtain a loan from the insurer. The DSOP proposed that an insurer should treat these loans as a prepayment of the insurance liability, rather than as the creation of a separate financial asset. Because the Board does not regard this issue as a priority, phase I does not address it.

Changes in accounting policies

Relevance and reliability

BC123 IAS 8 prohibits a change in accounting policies that is not required by an IFRS, unless the change will result in the provision of reliable and more relevant information. Although the Board wished to avoid imposing unnecessary changes in phase I, it saw no need to exempt insurers from the requirement to justify changes in accounting policies. Therefore, paragraph 22 of the IFRS permits an insurer to change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant and no less reliable or more reliable and no less relevant, judged by the criteria in IAS 8.* As the Board's conclusions for phase II develop (see paragraphs BC6-BC8), they will give insurers further context for judgements about whether a change in accounting policies will make their financial statements more relevant and reliable.

BC124 The IFRS contains further specific requirements supporting paragraph 22:

- (a) paragraph 24 permits an insurer to change its accounting policies for some insurance liabilities that it designates, without satisfying the normal requirement in IAS 8 that an accounting policy should be applied to all similar items (paragraphs BC174-BC177).
- (b) paragraph 25 permits the following practices to continue but prohibits their introduction:
 - (i) measuring insurance liabilities on an undiscounted basis (paragraphs BC126 and BC127).

* Unlike IAS 8, paragraph 22 of the IFRS permits changes in accounting policies that make the financial statements more reliable and no less relevant. This permits improvements that make financial statements more reliable even if they do not achieve full reliability. In IAS 8 and the *Framework*, reliability is not synonymous with verifiability but includes characteristics such as neutrality and substance over form.

- (ii) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraphs BC128- BC130).
- (iii) using non-uniform accounting policies for the insurance contracts of subsidiaries (paragraphs BC131 and BC132).
- (c) paragraph 26 prohibits the introduction of additional prudence if an insurer already measures insurance liabilities with sufficient prudence (paragraph BC133).
- (d) paragraphs 27-29 create a rebuttable presumption against the introduction of future investment margins in the measurement of insurance contracts (paragraphs BC134-BC144).
- (e) paragraph 30 addresses 'shadow accounting' (paragraphs BC181-BC184).
- (f) paragraph 45 permits an insurer to redesignate financial assets as 'at fair value through profit or loss' when it changes its accounting policies for insurance liabilities (paragraphs BC145 and BC146).

BC125 Some respondents suggested that phase I should not permit changes in accounting policies, to prevent lack of comparability (especially within a country) and management discretion to make arbitrary changes. However, the Board decided to permit changes in accounting policies for insurance contracts if they make the financial statements more relevant and no less reliable, or more reliable and no less relevant.

Discounting

BC126 In present practice, most general insurance claims liabilities are not discounted. In the Board's view, discounting of insurance liabilities results in financial statements that are more relevant and reliable. However, because the Board will not address discount rates and the basis for risk adjustments until phase II, the Board concluded that it could not require discounting in phase I. Nevertheless, the IFRS prohibits a change from an accounting policy that involves discounting to one that does not involve discounting (paragraph 25(a)).

BC127 Some respondents to ED 5 opposed discounting for contracts in which almost all the cash flows are expected to arise within one year, on materiality and cost-benefit grounds. The Board decided to create no specific exemption for these liabilities, because the normal materiality criteria in IAS 8 apply.

Investment management fees

BC128 Under some insurance contracts, the insurer is entitled to receive a periodic investment management fee. Some suggest that the insurer should, in determining the fair value of its contractual rights and obligations, discount the estimated future cash flows at a discount rate that reflects the risks associated with the cash flows. Some insurers use this approach in determining embedded values.

BC129 However, in the Board's view, this approach can lead to results that are not consistent with a fair value measurement. If the insurer's contractual asset management fee is in line with the fee charged by other insurers and asset managers for comparable asset management services, the fair value of the insurer's contractual right to that fee would be approximately equal to what it would cost insurers and asset managers to acquire similar contractual rights.* Therefore, paragraph 25(b) of the IFRS confirms that an insurer cannot introduce an accounting policy that measures those contractual rights at more than their fair value as implied by fees charged by others for comparable services; however, if an insurer's existing accounting policies involve such measurements, it may continue to use them in phase I.

BC130 The Board's agenda includes a project on revenue recognition.

Uniform accounting policies on consolidation

BC131 IAS 27 *Consolidated and Separate Financial Statements* requires entities to use uniform accounting policies.[#] However, under current national requirements, some insurers consolidate subsidiaries without conforming the measurement of insurance liabilities using the subsidiaries' own local GAAP to the accounting policies used by the rest of the group.

BC132 The use of non-uniform accounting policies reduces the relevance and reliability of financial statements. However, prohibiting this would force some insurers to change their accounting policies for the insurance liabilities of some subsidiaries in phase I. This could have required systems changes that might no longer be needed in phase II. Therefore, the Board decided that an insurer already using non-uniform accounting policies for insurance contracts could continue to do so in phase I. However, if an insurer already uses uniform accounting policies for insurance contracts, it could not switch to a policy of using non-uniform accounting policies (paragraph 25(c) of the IFRS).

Excessive prudence

BC133 Insurers sometimes measure insurance liabilities on what is intended to be a highly prudent basis that lacks the neutrality required by the *Framework*. However, phase I does not define how much prudence is appropriate and cannot, therefore, eliminate excessive prudence. Consequently, the IFRS does not attempt to prohibit existing measurements of insurance liabilities that lack neutrality because of excessive prudence. Nevertheless, it prohibits the introduction of additional prudence if an insurer already measures insurance liabilities with sufficient prudence (see paragraph 26 of the IFRS). The liability adequacy test in paragraphs 15-19 addresses the converse problem of understated insurance liabilities.

Future investment margins

BC134 In the Board's view, the cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability). Many existing measurement practices for insurance liabilities conflict with this principle because they use a discount rate based on the estimated return from the assets that are deemed to back the insurance liabilities. However, the Board concluded that it could not eliminate

* This approach is consistent with the discussion of servicing rights and obligations in IAS 39.

[#] The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011, but the accounting policy requirements were not changed.

these practices until phase II gives guidance on discount rates and the basis for risk adjustments.

BC135 ED 5 stated that an accounting policy change makes financial statements less relevant and reliable if it introduces a practice of including future investment margins. On the following grounds, some respondents opposed this proposal, which would have prohibited the introduction of any measurements that reflect future investment margins:

- (a) The proposal prejudices a phase II issue. Most actuaries and insurers believe that a fair value measure (ie one calibrated to transactions involving insurance contracts) must include some consideration of asset performance because product pricing, reinsurance and market transactions are observed to reflect this feature.
- (b) A current market rate results in more relevant and reliable information than an out-of-date discount rate prescribed by a regulator, even if the current market rate reflects expected asset returns.
- (c) Asset-based discount rates are a feature of most existing national systems, including some modern systems that use current estimates of future cash flows and current (albeit asset-based) discount rates. The prohibition proposed in ED 5 would have prevented an insurer from replacing its existing accounting policies for insurance contracts with another comprehensive basis of accounting for insurance contracts that is, in aggregate, more relevant and reliable despite the disadvantage of using an asset-based discount rate.
- (d) Because US GAAP uses an asset-based discount rate for some insurance liabilities, the prohibition would have prevented insurers from adopting US GAAP for their insurance liabilities in phase I. This would have been unfair because some insurers that have already adopted IFRSs apply US GAAP to their insurance contracts and could continue to do so in phase I.

BC136 In the light of these comments, the Board replaced the prohibition proposed in ED 5 with a rebuttable presumption, which could be overcome if the other components of a change in accounting policies increase the relevance and reliability of an insurer's financial statements sufficiently to outweigh the disadvantage of introducing the practice in question (see paragraph 28 of the IFRS for an example).

BC137 The IFRS identifies two practices that include future investment margins in the measurement of insurance liabilities: (a) using a discount rate that reflects the estimated return on the insurer's assets,^{*} (b) projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability. Some suggested that (b) should be eliminated in phase I because they regarded it as less acceptable than (a). However, the Board noted that although (b) appears more obviously incorrect than (a), these two practices have the same effect and are logically equivalent.

Future investment margins and embedded value

BC138 In addition to considering asset-based discount rates in general, the Board also considered a specific measurement technique that, at least in present practice, typically reflects future investment margins, namely embedded value. Embedded value is an indirect method of measuring an insurance liability. Indirect methods measure the liability by discounting all cash flows arising from both the book of insurance contracts and the assets supporting the book, to arrive at a net measurement for the contracts and supporting assets. The measurement of the assets is then deducted to arrive at a measurement of the book of contracts.[§] In contrast, direct methods measure the liability by discounting future cash flows arising from the book of insurance contracts only. If the same assumptions are made in both methods, direct and indirect methods can produce the same results.[‡]

BC139 Life insurers in an increasing number of countries disclose embedded value information. Most disclose this information outside the financial statements or as supplementary information (usually unaudited), but a few use it as a measurement in their balance sheets[†].

BC140 Some respondents felt that embedded value methodology is far more relevant and reliable than most local accounting methods, and insurers should be permitted to adopt it. They noted that embedded values are often an important consideration in determining prices for acquisitions of insurers and of blocks of insurance contracts. Furthermore, embedded value and similar indirect methods are often used in accounting for the insurance liabilities assumed in these acquisitions.

BC141 For the following reasons, some suggested that phase I should prohibit embedded value measurements in the balance sheet.

- (a) Embedded value approaches are largely unregulated at present and there is diversity in their application. For example, some view the methods used to

^{*} Some approaches attempt to find a portfolio of assets ('replicating portfolio') with characteristics that replicate the characteristics of the liability very closely. If such a portfolio can be found, it may be appropriate to use the expected return on the replicating portfolio as the discount rate for the liability, with suitable adjustments for differences in their characteristics. However, replicating portfolio approaches should not be regarded as using an asset-based discount rate because they attempt to measure the characteristics of the liability. They are not based on the characteristics of the actual assets held, which may or may not match those of the liability.

[§] If embedded values are recognised in the statement of financial position, they are typically presented as two components: an insurance liability and a separate intangible asset. This is similar to the expanded presentation that the IFRS permits in a business combination or portfolio transfer.

[‡] Luke N. Girard, *Market Value of Insurance Liabilities: Reconciling the Actuarial Appraisal and Option Pricing Methods*, North American Actuarial Journal, Volume 4, Number 1.

[†] IAS 1 *Presentation of Financial Statements* (as revised in 2007) replace the term 'balance sheet' with 'statement of financial position'.

reflect risk as fairly crude, diverse and not always fully consistent with capital market prices.

- (b) Embedded value methods today typically involve two practices whose introduction ED 5 regarded as unacceptable:
 - (i) reflecting future investment margins in the measurement of the ‘embedded value’ asset associated with insurance liabilities (see paragraphs BC134-BC144).
 - (ii) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (see paragraphs BC128-BC130).
- (c) In current practice, embedded values are generally determined on a single best estimate basis that does not reflect the full range of possible outcomes. This does not generally adequately address embedded guarantees and options, such as embedded interest rate guarantees. Until recently, embedded values would have ignored these items if they were out of the money. Indeed, in some cases, they might have been ignored even if they were in the money, because of assumptions about future investment performance. More attention is now being devoted to these options and guarantees and embedded value methods may begin to address them more rigorously, but that development is not yet complete.

BC142 However, for the following reasons, the IFRS permits continued use of embedded value measurements:

- (a) One objective of phase I is to avoid disturbing existing practice for insurance contracts, unless a change creates a significant improvement and leads in a direction consistent with the likely direction of phase II. Prohibiting the continued use of embedded values would not meet that criterion.
- (b) Embedded value methods are based on estimates of future cash flows, not an accumulation of past transactions. The advantages of this may, in some cases, outweigh the disadvantage of including future investment margins. Therefore, eliminating embedded value methods may not result in more relevant and reliable financial statements in every case.
- (c) Given that the Board did not prohibit asset-based discount rates for other measurements of insurance liabilities in phase I, there is no compelling reason in phase I to prohibit embedded value measurements that contain future investment margins.
- (d) Although embedded value measurements today typically include future investment margins, some practitioners have suggested improving embedded value methods by adjusting the asset cash flows fully for risk to make them consistent with market prices.

BC143 It follows from the Board’s conclusions on relevance and reliability (paragraphs BC123-BC125), investment management fees (paragraphs BC128-BC130) and future investment margins (paragraphs BC134-BC137) that an insurer can introduce embedded value measurements in its balance sheet only if all the following conditions are met:

- (a) the new accounting policy will result in more relevant and reliable financial statements (paragraph 22 of the IFRS). This is not an automatic decision and will depend on a comparison of the insurer's existing accounting with the way in which it intends to apply embedded value
- (b) this increase in relevance and reliability is sufficient to overcome the rebuttable presumption against including future investment margins (paragraph 29 of the IFRS).
- (c) the embedded values include contractual rights to future investment management fees at an amount that does not exceed their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraph 25(b) of the IFRS and paragraphs BC128-BC130).

BC144 In some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. However, in other approaches (such as most applications of embedded value), the discount rate determines the measurement of the liability directly. The Board concluded that it is highly unlikely that an insurer could overcome the rebuttable presumption in the latter case (see paragraph 29 of the IFRS).

Redesignation of financial assets

BC145 When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all financial assets as 'at fair value through profit or loss'. This permits an insurer to avoid artificial mismatches when it improves its accounting policies for insurance liabilities. The Board also decided:

- (a) not to restrict redesignation to assets backing the insurance contracts for which the accounting policies were changed. The Board did not wish to create unnecessary barriers for those insurers that wish to move to a more consistent measurement basis that reflects fair values.
- (b) not to introduce an option to reclassify financial assets as 'available for sale'[#]. Such reclassification would have caused changes in carrying amount to be recognised directly in equity for assets, but in profit or loss for insurance liabilities. An insurer can avoid this inconsistency by classifying the financial assets as 'at fair value through profit or loss'.

BC146 IAS 39^{*} permits redesignation of assets in specified circumstances when an entity adopts the revised IAS 39. IFRS 1 *First-time Adoption of International Financial Reporting Standards* contains corresponding provisions for first-time adopters.

Acquisition of insurance contracts in business combinations and portfolio transfers

BC147 When an entity acquires another entity in a business combination, IFRS 3 *Business Combinations* requires the acquirer to measure at fair value the identifiable assets and

[#] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

liabilities acquired. Similar requirements exist under many national accounting frameworks. Nevertheless, in practice, insurers have often used an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
- (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). Life insurers often describe this intangible asset by names such as the present value of in force business (PVIF), present value of future profits (PVFP or PVP) or value of business acquired (VOBA). Similar principles apply in non-life insurance, for example if claims liabilities are not discounted.

BC148 For the following reasons, the Board decided to permit these existing practices during phase I (paragraph 31 of the IFRS):

- (a) One objective of phase I is to avoid prejudging most phase II issues and to avoid requiring systems changes for phase I that might need to be reversed for phase II. In the meantime, disclosure about the nature of, and changes in, the related intangible asset provides transparency for users.
- (b) The IFRS gives no guidance on how to determine the fair value of the insurance liabilities, because that would be premature in phase I. Thus, fair values identified during phase I might need to be changed in phase II.
- (c) It may be difficult to integrate a fair value measurement at the date of a business combination into subsequent insurance contract accounting without requiring systems changes that could become obsolete in phase II.

BC149 The intangible asset described above is generally amortised over the estimated life of the contracts. Some insurers use an interest method of amortisation, which appears appropriate for an asset that essentially comprises the present value of a set of contractual cash flows. However, it is doubtful whether IAS 38 *Intangible Assets* would have permitted its use. Therefore, the Board decided that this asset should remain outside the scope of IAS 38 and its subsequent measurement should be consistent with the measurement of the related insurance liability (paragraph 31(b) of the IFRS). Because this asset would be covered by the liability adequacy test in paragraphs 15-19, the Board also excluded it from the scope of IAS 36 *Impairment of Assets*.

BC150 IAS 36 and IAS 38 still apply to customer lists and customer relationships reflecting the expectation of contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination. An illustrative example published with IFRS 3 deals with customer relationships acquired together with a portfolio of one-year motor insurance contracts.

BC151 Measurements of the intangible asset described in paragraph BC147(b) sometimes include future investment margins. Those margins are subject to the same requirements as future investment margins included in the measurement of the related insurance liability (see paragraphs BC134-BC144).

- BC152 In some cases, an insurer's accounting policies under previous GAAP (ie those used before it adopted IFRSs) involved measuring the intangible asset described in paragraph BC147(b) on a basis derived from the carrying amounts of other assets and liabilities. In such cases, if an entity changes the measurements of its assets and liabilities on adopting IFRSs for the first time, shadow accounting may become relevant (see paragraphs BC181-BC184 for a discussion of shadow accounting).
- BC153 Some respondents requested an exemption from fair value measurement for insurance liabilities assumed in a business combination. They argued that there is still too much uncertainty about how fair value should be defined and determined.* However, insurers have apparently been able to cope with the existing requirements in IFRSs and in national standards. The Board saw no compelling reason for a new exemption.

Discretionary participation features

- BC154 Some insurance contracts contain a discretionary participation feature as well as a guaranteed element. The insurer has discretion over the amount and/or timing of distributions to policyholders, although that discretion may be subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Distributions are typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit.
- BC155 Although the issuer has contractual discretion over distributions, it is usually likely that current or future policyholders will ultimately receive some part of the accumulated surplus available, at the reporting date, for distribution to holders of contracts with discretionary participation features (ie distributable surplus). The main accounting question is whether that part of the distributable surplus is a liability or a component of equity. The Board will explore that question in phase II.
- BC156 Features of this kind are found not only in insurance contracts but also in some investment contracts (ie financial liabilities). Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board might decide on a different treatment in phase II. Furthermore, in some cases, holders of insurance contracts and investment contracts have a contractual right to share in discretionary payments out of the same pool of assets. If the Board required a particular treatment for the discretionary participation features of the investment contracts in phase I, it might prejudice the treatment of these features in insurance contracts that are linked to the same pool of assets.
- BC157 For these reasons, the Board decided not to address most aspects of the accounting treatment of such features in phase I, in either insurance contracts or investment contracts. However, paragraphs 34 and 35 of the IFRS confirm that it is unacceptable to classify a discretionary participation feature as an intermediate category that is neither liability nor equity, because this would be inconsistent with the *Framework*. If a balance sheet item does not meet the *Framework*'s definition of, and recognition criteria for, assets or liabilities, that item is included in equity.

* IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

BC158 Furthermore, ED 5 proposed a requirement for the issuer of an investment contract containing such a feature to recognise a liability measured at no less than the amount that would result from applying IAS 39* to the guaranteed element of the contract. Because issuers need not determine the IAS 39 measurement of the guaranteed element if the total recognised liability is clearly higher, ED 5 noted the Board's expectation that issuers would not need extensive new systems to comply with this requirement.

BC159 Some respondents objected that determining the result of applying IAS 39 to the guaranteed element would either have virtually no effect (in which case the requirement would be unnecessary) or require extensive new systems (causing costs exceeding the likely benefit to users). In finalising the IFRS, the Board adopted a more flexible approach that limits the need for systems to apply IAS 39 to the guaranteed element alone, while still requiring some rigour to avoid the understatement of the financial liability. Specifically, paragraph 35 permits two approaches for a discretionary participation feature in a financial liability:

- (a) The issuer may classify the entire discretionary participation feature as a liability, but need not separate it from the guaranteed element (and so need not determine the result of applying IAS 39 to the guaranteed element). An issuer choosing this approach is required to apply the liability adequacy test in paragraphs 15-19 of the IFRS to the contract.
- (b) The issuer may classify part or all of the feature as a separate component of equity. If so, the liability recognised cannot be less than the result of applying IAS 39 to the guaranteed element. The issuer need not determine that measurement if the total liability recognised is clearly higher.

BC160 There may be timing differences between retained earnings under IFRSs and distributable surplus (ie the accumulated amount that is contractually eligible for distribution to holders of discretionary participation features). For example, distributable surplus may exclude unrealised investment gains that are recognised under IFRSs. The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases. The IFRS does not address the classification of these timing differences because the Board will not determine until phase II whether the distributable surplus is all equity, all liability or part equity and part liability.

BC161 The factor that makes it difficult to determine the appropriate accounting for these features is constrained discretion, in other words, the combination of discretion and constraints on that discretion. If participation features lack discretion, they are embedded derivatives and within the scope of IAS 39#.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

The Board amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

- BC162 The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a ‘crediting rate’ that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as ‘universal life’ contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer’s resources. The Board will revisit the treatment of these features in phase II.
- BC163 Some respondents asked the Board to clarify the treatment of premiums received for financial instruments containing discretionary participation features. Conceptually the premium for the guaranteed element is not revenue, but the treatment of the premium for the discretionary participation feature could depend on matters that will not be resolved until phase II. Furthermore, requiring the premium to be split could involve system changes that might become redundant in phase II. To avoid unnecessary disruption in phase I, the Board decided that entities could continue presenting premiums as revenue, with a corresponding expense representing the change in the liability.
- BC164 Conceptually, if part or all of a discretionary participation feature is classified as a component of equity, the related portion of the premium should not be included in profit or loss. However, the Board concluded that requiring each incoming premium to be split would require systems changes beyond the scope of phase I. Therefore, the Board decided that an issuer could recognise the entire premium as revenue without separating the portion that relates to the equity component. However, the Board confirmed that the portion of profit or loss attributable to the equity component is presented as an allocation of profit or loss (in a manner similar to the presentation of minority interests*), not as expense or income.
- BC165 Some suggested that investment contracts containing a discretionary participation feature should be excluded from the fair value disclosure required by IAS 32[†].[‡] They noted both conceptual and practical problems in determining the fair value of an instrument of this kind. However, instead of creating a new exclusion from the required disclosure of fair value, the Board added new paragraph 91A to IAS 32. This extends existing requirements in IAS 32 governing those unquoted equity instruments whose fair value cannot be determined reliably.

* In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended ‘minority interests’ to ‘non-controlling interests’. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The term ‘non-controlling interests’ and the requirements for non-controlling interests were not changed.

~~‡ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.~~

[†] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

Issues related to IAS 39[#]

Assets held to back insurance contracts

BC166 The IFRS does not address financial or non-financial assets held by insurers to back insurance contracts.^α IAS 39 identifies four categories of financial asset, with three different accounting treatments. In developing IAS 39, the Board's predecessor (IASC) acknowledged that most countries had a mixed measurement model, measuring some financial assets at amortised cost and others at fair value. IASC decided to retain, but regulate and structure, the different approaches as follows:

- (a) financial assets classified as 'at fair value through profit or loss' (including all financial assets held for trading) are measured at fair value, with all changes in their fair value recognised in profit or loss. Furthermore, all derivatives are deemed to be held for trading, and hence measured at fair value, because this is the only method that provides sufficient transparency in the financial statements.
- (b) available-for-sale assets (ie those that do not fall into any of the other categories) are measured at fair value, with changes in their fair value recognised in equity until the asset is derecognised or becomes impaired. Measurement at fair value is appropriate given that available-for-sale assets may be sold in response to, for example, changes in market prices or a liquidity shortage.
- (c) assets with a fixed maturity may be measured at amortised cost if the entity intends to hold them to maturity and shows that it has the ability to do so. This treatment is based on the view of some that changes in market prices are irrelevant if an asset is held to maturity because those changes will reverse before maturity (unless the asset becomes impaired).
- (d) loans and receivables are measured at amortised cost. IASC was persuaded that there are difficulties in estimating the fair value of such loans, and that further progress was needed in valuation techniques before fair value should be required.

BC167 Some expressed concerns that accounting mismatches would arise in phase I if financial assets (particularly interest-bearing investments) held to back insurance contracts are measured at fair value under IAS 39 whilst insurance liabilities are measured on a different basis. If the insurer classifies the assets as 'available for sale', this difference in measurement basis would not affect profit or loss but it could lead to some volatility in equity. Some do not regard that volatility as a faithful representation of changes in the insurer's financial position. In developing ED 5, after

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39, unless an insurer applies the temporary exemption from IFRS 9 in paragraphs 20A-20Q and 39B-39J of IFRS 4. That temporary exemption is discussed in paragraphs BC228-BC299.

^α IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

^α IFRS 9 applies to an insurer's financial assets, including financial assets held to back insurance contracts. In September 2016, the Board issued *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)* to address concerns arising from the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. Those amendments include a temporary exemption from IFRS 9 for insurers that meet specified criteria and an option for insurers to apply the overlay approach to designated financial assets.

discussing various suggestions for reducing that volatility,* the Board decided:

- (a) not to relax the criteria in IAS 39 for classifying financial assets as ‘held to maturity’. Relaxing those criteria would undermine the fundamental assertion that an entity has both the intent and ability to hold the assets until maturity. The Board noted that an insurer may be able to classify some of its fixed maturity financial assets as held to maturity if it intends not to sell them before maturity and, in addition to meeting the other conditions set out in IAS 39, concludes that an unexpected increase in lapses or claims would not compel it to sell those assets (except in the ‘disaster scenario’ discussed in IAS 39 paragraph AG21).
- (b) not to create a new category of assets carried at amortised cost: assets held to back insurance liabilities. The creation of such a category would lead to a need for arbitrary distinctions and complex attribution procedures that would not make an insurer’s financial statements more relevant and reliable, and could require insurers to develop costly systems. The Board reviewed a precedent that exists in Japan for such a category, but was not persuaded that the procedures adopted there can overcome these difficulties. Moreover, if an insurer may sell assets in response to, for example, changes in market prices or a liquidity shortage, the only appropriate measurement is fair value.
- (c) not to create a new category of ‘available-for-settlement’ liabilities, analogous to available-for-sale assets, measured at fair value, with changes in fair value recognised in equity. The creation of such a category would make it necessary to find some basis for distinguishing between that category and the existing category of non-trading financial liabilities, or to permit a free choice of accounting treatments. The Board has identified no basis for such a distinction, nor for deciding which of these two categories would be the new residual category. Furthermore, creating such a category could require insurers to develop new systems with no certainty that those systems would be needed in phase II.

BC168 In developing ED 5, the Board concluded that the reasons given above outweigh the effects of any accounting mismatch on an insurer’s reported equity. Therefore, the Board decided not to exempt insurers from these existing requirements, even temporarily.

BC169 Insurers may be particularly sensitive to equity reported in general purpose financial statements in some countries where this amount is used in assessing compliance with regulatory capital requirements. However, although insurance supervisors are important users of general purpose financial statements, those financial statements are not directed at specific needs of insurance supervisors that other users do not share. Furthermore, supervisors generally have the power to obtain additional information that meets their specific needs. In the Board’s view, creating new exemptions from IAS 39 in this area would not have been the best way to meet the common needs of users (including insurance supervisors) of an insurer’s general purpose financial statements.

* The Board discussed this subject at its meeting in November 2002. It was also one of the major topics raised by insurance participants at two half-day sessions during the financial instruments round-tables in March 2003. Before finalising ED 5, the Board discussed the subject again in April 2003.

BC170 Some argued that banks enjoy an ‘advantage’ that is not available to insurers. Under IAS 39, a bank may measure its core banking-book assets and liabilities (loans and receivables and non-trading financial liabilities) at amortised cost, whereas an insurer would have no such option for many of the assets held to back its core insurance activities. However, as noted in paragraph BC166(d), IASC permitted amortised cost measurement for loans and receivables because it had concerns about difficulties in establishing their fair value. This factor does not apply to many assets held by insurers to back insurance liabilities.

BC171 Many of the respondents to ED 5 urged the Board to explore ways of reducing the accounting mismatch described above. The Board discussed this subject at length at all three meetings at which it discussed the responses to ED 5 before finalising the IFRS. In addition, the Board discussed it with the Standards Advisory Council. It was also raised at a meeting of the Board’s Insurance Advisory Committee in September 2003, which six Board members attended together with the project staff. Individual Board members and staff also had many discussions with interested parties, including users, insurers, actuaries, auditors and regulators.

BC172 It is important to distinguish two different types of mismatch:

- (a) *accounting mismatch* arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities.
- (b) *economic mismatch* arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. It is worth noting that economic mismatch is not necessarily eliminated by an asset-liability management programme that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities.

BC173 Ideally, a measurement model would report all the economic mismatch that exists and would not report any accounting mismatch. The Board considered various alternatives, observing that all had advantages and disadvantages. Some alternatives would have amended IAS 39 to extend the use of cost or amortised cost measurements. However, the Board noted the following:

- (a) Fair value is a more relevant measurement than amortised cost for financial assets that an entity might sell in response to changing market and other conditions.
- (b) In its response to ED 5, the Association for Investment Management and Research (AIMR) strongly urged the Board not to extend the use of amortised cost in IAS 39. The AIMR is a non-profit professional association of more than 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries.
- (c) An accounting model that measured both assets and liabilities at amounts based on current interest rates would provide information about the degree of economic mismatch. A model that measured both at historical values, or ignored the time value of money in measuring some insurance liabilities, would not. Financial analysts often observe that information about economic mismatch is very important to them.

- (d) Some suggested that insurers wish to follow a strategy that involves holding fixed maturity investments to maturity, with some flexibility to sell investments if insurance claims or lapses are unusually high. They recommended relaxing restrictions in IAS 39 so that insurers using such a strategy could use the held-to-maturity category more easily. However, in discussions with individual Board members and staff, insurers generally indicated that they also wished to keep the flexibility to make sales in the light of changing demographic and economic conditions so that they can seek the best trade-off between risk and return. That is a valid and understandable business objective, but it is difficult to argue that cost could be more relevant than fair value in such cases. Although IAS 32* requires disclosure of the fair value of financial assets carried at amortised cost, disclosure does not rectify inappropriate measurement.
- (e) Some noted that they wished to keep the flexibility to sell corporate bonds before a major downgrade occurs. They viewed the guidance in IAS 39 as restricting their ability to do this. Moreover, because a ‘tainting’ requirement in IAS 39 prohibits the use of the held-to-maturity category after most sales from this category, insurers are reluctant to use this classification for corporate bonds. The application guidance in IAS 39 gives examples of cases when sales of held-to-maturity investments do not ‘taint’ all other such investments. For example, paragraph AG22(a) of IAS 39 refers to a sale following a significant deterioration in the issuer’s creditworthiness. The Board noted that some appeared to read that guidance as limited to changes in a credit rating by an external credit rating agency, although the guidance also refers to internal ratings that meet particular criteria.
- (f) The Japanese precedent mentioned in paragraph BC167(b) creates some discipline by placing restrictions on the use of amortised cost, but for systems or other reasons not all insurers in Japan adopt this approach. Furthermore, this approach permits a cost approach if the durations (ie average maturities) of insurance liabilities match those of the related assets within a specified band of 80-125 per cent. If any economic mismatch arises within that band, this approach does not recognise it. In addition, gains and losses on selling assets held at amortised cost are generally recognised immediately in profit or loss (except that some gains are deferred and amortised if sales are not compatible with the duration matching strategy).
- (g) Some Board members and staff met representatives of major European insurers to explore the possibility of (i) extending the use of amortised cost if specified, relatively strict, criteria are met and (ii) combining that with a simplified attempt to identify ‘ineffectiveness’ resulting from the fact that the assets and liabilities would not respond identically to changes in interest rates. This approach would have avoided some of the practical and conceptual problems inherent in the Japanese approach discussed above. However, this untried approach had been developed at short notice and not all details had been worked through. Moreover, many insurers may not be able or willing to invest in systems that could need amendment in phase II.

* In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

- (h) That a mixed measurement model can create an accounting mismatch is undeniable. Furthermore, it costs time and money for insurers to explain the effects even to sophisticated users. Insurers are very concerned that less sophisticated users may misinterpret the resulting information. If a simple, transparent and conceptually acceptable way could have been found to eliminate the accounting mismatch at an acceptable cost without also obscuring the economic mismatch, that change might have been beneficial. However, the Board could find no such way in the short term. The Board also noted that any change could have required major systems changes and that there appeared to be no consensus among insurers on a single method.
- (i) Extending the use of amortised cost would have created an inconsistency with US GAAP. The accounting mismatch described in paragraphs BC167 and BC172 has existed for some years in US GAAP, which requires insurers to account for their financial assets in broadly the same way as under IAS 39. Furthermore, the US Financial Accounting Standards Board decided in January 2004 not to add to its agenda a project to reconsider US GAAP for investments held by life insurance companies.

BC174 In the light of these considerations, the Board concluded that changing the measurement requirements in IAS 39 for financial assets, even temporarily, would diminish the relevance and reliability of an insurer's financial statements. The Board observed that the accounting mismatch arose more from imperfections in existing measurement models for insurance liabilities than from deficiencies in the measurement of the assets. It would have been a retrograde step to try to mitigate the accounting mismatch by adopting a less relevant measurement of the assets—a measurement that would also have obscured some of the economic mismatch.

BC175 The Board considered whether it could mitigate the accounting mismatch by permitting improvements to the measurement of insurance liabilities. The Board noted that introducing a current market-based discount rate for insurance liabilities rather than a historical discount rate would improve the relevance and reliability of an insurer's financial statements. Therefore, such a change would have been permitted by the proposals in ED 5 and is also permitted by the IFRS. However, IAS 8 requires consistent accounting policies for similar transactions. For systems and other reasons, some insurers may not wish, or be able, in phase I to introduce a current market-based discount rate for all insurance liabilities.

BC176 The Board concluded that the increase in relevance and reliability from introducing a current discount rate could outweigh the disadvantages of permitting accounting policies that are not applied consistently to all similar liabilities. Accordingly, the Board decided to permit, but not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require. The Board noted that insurers might sometimes be able to develop simplified models that give a reasonable estimate of the effect of interest rate changes.

BC177 The Board also noted the following:

- (a) No single proposal would have eliminated the accounting mismatch for a broad cross-section of insurers without also obscuring the economic mismatch.
- (b) No single proposal would have been acceptable to a broad cross-section of insurers.
- (c) No single proposal could have been implemented by a broad cross-section of insurers without major systems changes. In other words, no solution was available that built on common industry approaches and systems. Furthermore, the systems needed to implement successfully the approach discussed with some European insurers (see paragraph BC173(g)) would also allow the approach permitted by paragraph 24 of the IFRS (adjusting designated liabilities for changes in interest rates). Indeed, paragraph 24 imposes fewer restrictions than the approach discussed with European insurers because it does not require the assets to match the liability cash flows closely, since any mismatch in cash flows is reflected in profit or loss.
- (d) Adjusting the discount rate for designated liabilities will not eliminate all the accounting mismatch described above and some, perhaps many, insurers will choose not to make that adjustment. The reasons for this are as follows:
 - (i) As noted above, many insurers may not have systems to adjust liabilities for changes in interest rates and may not wish to develop such systems, even for designated liabilities as opposed to all liabilities.
 - (ii) Changes in discount rates would not affect the measurement of insurance liabilities that are carried at an accumulated account value.
 - (iii) Changes in discount rates would not affect the measurement of financial liabilities with a demand feature, because IAS 39 states that their fair value is not less than the amount payable on demand (discounted, if applicable, from the first date when that amount could be required to be paid). Although this last point is not strictly relevant for insurance contracts, many life insurers issue investment contracts for which it is relevant.

BC178 In summary, the Board decided not to amend existing measurement requirements in IAS 39 for financial assets because such amendments would have reduced the relevance and reliability of financial statements to an unacceptable extent. Although such amendments could have eliminated some of the accounting mismatch, they would also have obscured any economic mismatch that exists. The following points summarise amendments made to ED 5 that might mitigate the accounting mismatch in some cases, as well as relevant observations made by the Board:

- (a) The Board decided to permit, but not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates (see paragraph BC176).
- (b) The Board clarified the applicability of the practice sometimes known as 'shadow accounting' (paragraphs BC181-BC184).

- (c) The Board amended IAS 40 *Investment Property* to permit two separate elections when an entity selects the fair value model or the cost model for investment property. One election is for investment property backing contracts (which could be either insurance contracts or financial instruments) that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property. The other election is for all other investment property (see paragraph C12 of the IFRS).^{*}
- (d) The Board observed that some entities appeared to have misread the application guidance in IAS 39 on sales of held-to-maturity investments following a significant deterioration in the issuer's creditworthiness. Specifically, as noted in paragraph 173(e), some appeared to have read it as limited to changes in a credit rating by an external credit rating agency, although the guidance also refers to internal ratings that meet particular criteria.
- (e) The Board observed that IAS 1 and IAS 32 do not preclude a presentation identifying a separate component of equity to report a portion of the change (and cumulative change) in the carrying amount of fixed-maturity available-for-sale financial assets. An insurer could use such a presentation to highlight the effect on equity of changes in interest rates that (i) changed the carrying amount of assets but (ii) did not change the carrying amount of liabilities that respond economically to those changing interest rates.

BC179 IAS 40 permits an entity to use a fair value model for investment property, but IAS 16 does not permit this model for owner-occupied property. An entity may measure its owner-occupied property at fair value using the revaluation model in IAS 16, but changes in its fair value must be recognised in revaluation surplus rather than in profit or loss. Some insurers regard their owner-occupied property as an investment and prefer to use a fair value model for it. However, the Board decided not to make piecemeal changes to IAS 16 and IAS 40 at this stage.

BC180 The Board noted that shadow accounting (paragraphs BC181-BC184) may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an insurer elects to use shadow accounting, changes in the measurement of the liability resulting from revaluations of the property are recognised directly in equity, through the statement of changes in equity.

Shadow accounting

BC181 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities.[†]

BC182 When many of those models were constructed, unrealised gains and most unrealised losses were not recognised in financial statements. Some of those models were extended later to require some financial assets to be measured at fair value, with changes in fair value recognised directly in equity (ie the same treatment as for available-for-sale financial assets under IAS 39). When this happened, a practice

^{*} The amendments contained in paragraph C12 are now incorporated as paragraphs 32A-32C of IAS 40.

[†] Throughout this section, references to insurance liabilities are also relevant for (a) related deferred acquisition costs and (b) intangible assets relating to insurance contracts acquired in a business combination or portfolio transfer.

sometimes known as ‘shadow accounting’ was developed with the following two features:

- (a) A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.
- (b) If unrealised gains or losses on an asset are recognised directly in equity, the resulting change in the carrying amount of the insurance liability is also recognised in equity.

BC183 Some respondents asked the Board to clarify whether the proposals in ED 5 permitted shadow accounting. The Board concluded the following:

- (a) In principle, gains and losses on an asset should not influence the measurement of an insurance liability (unless the gains or losses on the asset alter the amounts payable to policyholders). Nevertheless, this is a feature of some existing measurement models for insurance liabilities and the Board decided that it was not feasible to eliminate this practice in phase I (see paragraph BC134 for further discussion in the context of future investment margins).
- (b) Shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (i) the gains and losses are realised or unrealised and (ii) unrealised gains and losses are recognised in profit or loss or directly in equity. This is a logical application of a feature of some existing models.
- (c) Because the Board does not expect that feature of existing models to survive in phase II, insurers should not be required to develop systems to apply shadow accounting.
- (d) If an unrealised gain or loss on an asset triggers a shadow accounting adjustment to a liability, that adjustment should be recognised in the same way as the unrealised gain or loss.
- (e) In some cases and to some extent, shadow accounting might mitigate volatility caused by differences between the measurement basis for assets and the measurement basis for insurance liabilities. However, that is a by-product of shadow accounting and not its primary purpose.

BC184 Paragraph 30 of the IFRS permits, but does not require, shadow accounting. The Implementation Guidance includes an illustrative example to show how shadow accounting might become relevant in an environment where the accounting for assets changes so that unrealised gains are recognised (IG Example 4). Because the Board does not expect the feature underlying the use of shadow accounting to survive in phase II, the Board decided not to give further guidance.

Investment contracts

BC185 Many insurers issue investment contracts (ie financial instruments that do not transfer enough insurance risk to qualify as insurance contracts). Under IAS 39, the issuer measures investment contracts at either amortised cost or, with appropriate designation at inception, at fair value. Some aspects of the measurements under IAS 39 differ from the measurements that are often used at present under national accounting requirements for these contracts:

- (a) The definition and treatment of transaction costs under IAS 39 may differ from the definition and treatment of acquisition costs in some national requirements.
- (b) The condition in IAS 39 for treating a modification of a financial liability (or the exchange of the new liability for an old liability) as an extinguishment of the original liability may differ from equivalent national requirements.
- (c) Future cash flows from assets do not affect the amortised cost or fair value of investment contract liabilities (unless the cash flows from the liabilities are contractually linked to the cash flows from the assets).
- (d) The amortised cost of a financial liability is not adjusted when market interest rates change, even if the return on available assets is below the effective interest rate on the liability (unless the change in rates causes the liability cash flows to change).
- (e) The fair value of a financial liability with a demand feature is not less than the amount payable on demand.
- (f) The fair value of a financial instrument reflects its credit characteristics.—*
- (g) Premiums received for an investment contract are not recognised as revenue under IAS 39, but as balance sheet movements, in the same way as a deposit received.

BC186 Some argued that the Board should not require insurers to change their accounting for investment contracts in phase I because the scope of phase I is intended to be limited and because the current treatment of such contracts is often very similar to the treatment of insurance contracts. However, the Board saw no reason to delay the application of IAS 39 to contracts that do not transfer significant insurance risk. The Board noted that some of these contracts have features, such as long maturities, recurring premiums and high initial transaction costs, that are less common in other financial instruments. Nevertheless, applying a single set of accounting requirements to all financial instruments will make an insurer's financial statements more relevant and reliable.

BC187 Some contracts within the scope of IAS 39 grant cancellation or renewal rights to the holder. The cancellation or renewal rights are embedded derivatives and IAS 39 requires the issuer to measure them separately at fair value if they are not closely related to their host contract (unless the issuer elects to measure the entire contract at fair value).

Embedded derivatives

BC188 Some suggested that the Board should exempt insurers from the requirement to separate embedded derivatives contained in a host insurance contract and measure them at fair value under IAS 39. They argued that:

- (a) separating these derivatives would require extensive and costly systems changes that might not be needed for phase II.

* IFRS 13, issued in May 2011, states that the fair value of a liability reflects the effect of non-performance risk, which includes, but may not be limited to, an entity's own credit risk.

- (b) some of these derivatives are intertwined with the host insurance contract in a way that would make separate measurement arbitrary and perhaps misleading, because the fair value of the whole contract might differ from the sum of the fair values of its components.

BC189 Some suggested that the inclusion of embedded options and guarantees in the cash flows used for a liability adequacy test could permit the Board to exempt some embedded derivatives from fair value measurement under IAS 39. Most proponents of this exemption implied that including only the intrinsic value of these items (ie without their time value) would suffice. However, because excluding the time value of these items could make an entity's financial statements much less relevant and reliable, the Board did not create such an exemption.

BC190 In the Board's view, fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. The cost of most derivatives is nil or immaterial. Hence if derivatives were measured at cost, they would not be included in the balance sheet and their success (or otherwise) in reducing risk, or their role in increasing risk, would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to users the nature of the rights and obligations inherent in derivatives.

BC191 IAS 39 requires entities to account separately for derivatives embedded in non-derivative contracts. This is necessary:

- (a) to ensure that contractual rights and obligations that create similar risk exposures are treated in the same way whether or not they are embedded in a non-derivative contract.
- (b) to counter the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative contract.

BC192 The requirement to separate embedded derivatives already applied to a host contract of any kind before the IFRS was issued. Exempting insurance contracts from that existing requirement would have been a retrograde step. Furthermore, much of the effort needed to measure embedded derivatives at fair value arises from the need to identify the derivatives and from other steps that will still be needed if the Board requires fair value measurement for phase II. In the Board's view, the incremental effort needed to identify the embedded derivatives separately in phase I is relatively small and is justified by the increased transparency that fair value measurement brings. IG Example 2 in the Implementation Guidance gives guidance on the treatment of various forms of embedded derivative.

BC193 Some embedded derivatives meet the definition of an insurance contract. It would be contradictory to require a fair value measurement in phase I of an insurance contract that is embedded in a larger contract when such measurement is not required for a stand-alone insurance contract. Therefore, the IFRS confirms that this is not required (paragraph 8). For the same reason, the Board concluded that an embedded derivative is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (see new paragraph AG33(h) of IAS 39). Without this

conclusion, paragraph 12 of IAS 39 would have required the insurer to measure the entire contract at fair value. An alternative approach would have been to retain that requirement, but require measurement at cost if an insurance contract cannot be measured reliably at fair value in its entirety, building on a similar treatment in IAS 39 for unquoted equity instruments. However, the Board did not intend to require fair value measurement for insurance contracts in phase I. Therefore, the Board decided not to require this even when it is possible to measure reliably the fair value of an insurance contract containing an embedded derivative.

BC194 The Board acknowledges that insurers need not, during phase I, recognise some potentially large exposures to items such as guaranteed annuity options and guaranteed minimum death benefits. These items create risks that many regard as predominantly financial, but if the payout is contingent on an event that creates significant insurance risk, these embedded derivatives meet the definition of an insurance contract. The IFRS requires specific disclosures about these items (paragraph 39(e)). In addition, the liability adequacy test requires an entity to consider them (see paragraphs BC94-BC104).

Elimination of internal items

BC195 Some respondents suggested that financial instruments issued by one entity to a life insurer in the same group should not be eliminated from the group's consolidated financial statements if the life insurer's assets are earmarked as security for policyholders' savings.

BC196 The Board noted that these financial instruments are not assets and liabilities from the group's perspective. The Board saw no justification for departing from the general principle that all intragroup transactions are eliminated, even if they are between components of an entity that have different stakeholders, for example policyholder funds and shareholder funds. However, although the transactions are eliminated, they may affect future cash flows. Hence, they may be relevant in measuring liabilities.

BC197 Some respondents argued that non-elimination would be consistent with the fact that financial instruments issued can (unless they are non-transferable) be plan assets in defined benefit plans under IAS 19 *Employee Benefits*. However, the Board did not view IAS 19 as a precedent in this area. IAS 19 requires a presentation net of plan assets because investment in plan assets reduces the obligation (IAS 19 Basis for Conclusions paragraph BC66). This presentation does not result in the recognition of new assets and liabilities.

Issues related to IFRS 9

BC197A In July 2014, the Board issued the completed version of IFRS 9 *Financial Instruments*. It replaces IAS 39 and has an effective date of 1 January 2018. In September 2016, the Board issued *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)* to address concerns arising from the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. Those amendments are discussed in paragraphs BC228–BC299.

Income taxes

BC198 Some respondents argued that discounting should be required, or at least permitted, for deferred tax relating to insurance contracts. The Board noted that discounting of a temporary difference is not relevant if an item's tax base and carrying amount are both determined on a present value basis.

Disclosure

BC199 The disclosure requirements are designed as a pair of high level principles, supplemented by some specified disclosures to meet those objectives. Implementation Guidance, published in a separate booklet*, discusses how an insurer might satisfy the requirements.

BC200 Although they agreed that insurers should be allowed flexibility in determining the levels of aggregation and amount of disclosure, some respondents suggested that the Board should introduce more specific and standardised disclosure requirements. Others suggested that the draft Implementation Guidance published with ED 5 was at too high a level to ensure consistency and comparability and that its non-mandatory nature might diminish its usefulness. Some were concerned that different levels of aggregation by different insurers could reduce comparability.

BC201 Nevertheless, the Board retained ED 5's approach. The Board viewed this as superior to requiring a long list of detailed and descriptive disclosures, because concentrating on the underlying principles:

- (a) makes it easier for insurers to understand the rationale for the requirements, which promotes compliance.
- (b) avoids 'hard-wiring' into the IFRS disclosures that may become obsolete, and encourages experimentation that will lead to improvements as techniques develop.
- (c) avoids requiring specific disclosures that may not be needed to meet the underlying objectives in the circumstances of every insurer and could lead to information overload that obscures important information in a mass of detail.
- (d) gives insurers flexibility to decide on an appropriate level of aggregation that enables users to see the overall picture but without combining information that has different characteristics.

BC202 Some respondents expressed the following general concerns about the proposed disclosure requirements in ED 5:

- (a) The proposed volume of disclosure was excessive and some of it would duplicate extensive material included in some countries in prudential returns.
- (b) Some of the proposed disclosures would be difficult and costly to prepare and audit, make it difficult to prepare timely financial statements and provide users with little value.

* but included in this volume.

- (c) The proposals in ED 5 would require excessive disclosure of sensitive pricing information and other confidential proprietary information.
- (d) Some of the disclosures exceeded those required in other industries, which singled out insurers unfairly. Some felt that the level of disclosure would be particularly burdensome for small insurers, whereas others referred to the difficulty of aggregating information in a meaningful way for large international groups.

BC203 The two principles and most of the supporting requirements are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements (particularly IFRS 7 *Financial Instruments: Disclosures*).

BC203A IFRS 7 was issued in August 2005 and replaced the disclosure requirements in IAS 32, including those on which the disclosures originally in IFRS 4 were based. Accordingly, the Board amended the disclosure requirements in IFRS 4 to be consistent with IFRS 7, when possible. The Board noted that:

- (a) insurers will have both insurance contracts and financial instruments. In particular, some of the investment products issued by insurers are financial instruments, not insurance contracts as defined in IFRS 4. It is more useful for users and easier for preparers if the risk disclosures for insurance contracts and financial instruments are the same.
- (b) making the disclosure requirements of IFRS 4 consistent with IFRS 7 makes the disclosures easier to prepare. In particular, IFRS 7 removes the “terms and conditions” disclosure previously in paragraph 39(b) of IFRS 4. Some commentators on ED 5 (the Exposure Draft that preceded IFRS 4) objected to this disclosure requirement, believing it to be onerous and not to provide the most useful information.
- (c) the disclosures in IFRS 7 are designed to be implemented as a package, and if implemented piecemeal would result in less useful information for users. For example, the risk disclosures replace the “terms and conditions” disclosure previously in paragraph 60(a) of IAS 32 and paragraph 39(b) of IFRS 4. Merely updating the reference in paragraph 39(d) from IAS 32 to IFRS 7 would have resulted in some, but not all, of the risk disclosures being applicable to insurance contracts and the “terms and conditions” disclosure being retained.
- (d) as discussed in paragraph BC207, significant changes to the risk disclosures in paragraphs 38-39A are not expected as a result of phase II of the project on insurance contracts (although consequential changes may be needed to the accounting-related disclosures in paragraphs 36 and 37).

BC203B Some respondents, particularly preparers, did not agree that IFRS 4 should be amended as part of IFRS 7. In particular, some respondents argued that sensitivity analysis of market risk would be problematic for insurance contracts; they disagreed that such an analysis would be relatively easy to understand or calculate while issues relating to the measurement of fair value for insurance contracts remain unresolved. Those respondents suggested that disclosure requirements on sensitivity analysis should be considered during phase II of the project on insurance contracts, rather than in finalising IFRS 7. The Board noted that this requirement should not be unduly onerous for insurers, nor require them to provide quantitative information, because the sensitivity

analysis applies only to changes in market risk variables that have an effect on profit or loss and equity in the period being reported. In addition, the Board noted that a sensitivity analysis is intended to replace the terms and conditions disclosures, which entities found onerous. The Board did not want to *require* insurers to comply with the older terms and conditions disclosures while allowing other entities to use the less onerous sensitivity analysis. However, the Board also noted that providing the sensitivity analysis would mean systems changes for some entities. Because the purpose of IFRS 4 was to minimise such changes pending the outcome of phase II, the Board did not want to require extensive systems changes for insurance contracts as a result of IFRS 7.

BC203C To address the concerns of those who do not want to make systems changes and those who want to substitute the new sensitivity analysis for the terms and conditions disclosures, the Board decided to permit a choice of sensitivity analysis disclosures for insurance risk only. Paragraph 39A of IFRS 4 has been added so that entities will be able to choose between providing:

- (a) the terms and conditions disclosures, together with the qualitative sensitivity analysis currently permitted by IFRS 4; or
- (b) the quantitative sensitivity analysis required by IFRS 7 (and permitted, but not required, by IFRS 4).

The Board permitted entities to choose to disclose a combination of qualitative and quantitative sensitivity analysis for insurance risk because it believes that entities should not be prevented from providing more useful information for some insurance risks, even if they do not have the ability to provide this information for all insurance risks. The Board noted that this option was a temporary solution to the problems cited in paragraph BC203B and would be eliminated in phase II.

BC204 Many respondents asked the Board to clarify the status of the Implementation Guidance. In particular, some felt that the Implementation Guidance appeared to impose detailed and voluminous requirements that contradicted the Board's stated intention in paragraph BC201. In response to requests from respondents, the Board added paragraph IG12 to clarify the status of the implementation guidance on disclosure.

BC205 Some suggested that some of the disclosures, particularly those that are qualitative rather than quantitative or convey management's assertions about possible future developments, should be located outside the financial statements in a financial review by management. However, in the Board's view, the disclosure requirements are all essential and should be part of the financial statements.

BC206 Some argued that the disclosure requirements could be particularly onerous and less relevant for a subsidiary, especially if the parent guarantees the liabilities or the parent reinsures all the liabilities. However, the Board decided that no exemptions from the disclosure principles were justified. Nevertheless, the high level and flexible approach adopted by the Board enables a subsidiary to disclose the required information in a way that suits its circumstances.

- BC207 Some respondents expressed concerns that the disclosure proposals in ED 5 might require extensive systems changes in phase I that might not be needed in phase II. The Board expects that both disclosure principles will remain largely unchanged for phase II, although the guidance to support them may need refinement because different information will be available and because insurers will have experience of developing systems to meet the disclosure principles in phase I.

Materiality

- BC208 Some respondents expressed concerns that the IFRS (reinforced by the Implementation Guidance) might require disclosure of excessively detailed information that might not be beneficial to users. In response to these concerns, the Board included in the Implementation Guidance a discussion of materiality taken from IAS 1.
- BC209 Some respondents suggested that some of the qualitative disclosures should not be subject to the normal materiality threshold, which might, in their view, lead to excessive disclosure. They proposed using different terminology, such as ‘significant’, to reinforce that message. However, the Board noted that not requiring disclosure of material information would be inconsistent with the definition of materiality. Thus, the Board concluded that the disclosure should, in general, rely solely on the normal definition of materiality.
- BC210 In one place, the IFRS refers to a different notion. Paragraph 37(c) refers to ‘the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts. Because many assumptions could be relevant, the Board decided to narrow the scope of the disclosure somewhat.

Explanation of recognised amounts

Assumptions

- BC211 The first disclosure principle in the IFRS requires disclosure of amounts in an insurer’s balance sheet ^{*} and income statement [†] that arise from insurance contracts (paragraph 36 of the IFRS). In support of this principle, paragraph 37(c) and (d) requires disclosure about assumptions and changes in assumptions. The disclosure of assumptions both assists users in testing reported information for sensitivity to changes in those assumptions and enhances their confidence in the transparency and comparability of the information.
- BC212 Some expressed concerns that information about assumptions and changes in assumptions might be costly to prepare and of limited usefulness. There are many possible assumptions that could be disclosed: excessive aggregation would result in meaningless information, whereas excessive disaggregation could be costly, lead to information overload, and reveal commercially sensitive information. In response to these concerns, the disclosure about the assumptions focuses on the process used to derive them.

^{*} IAS 1 *Presentation of Financial Statements* (as revised in 2007) replaced the term ‘balance sheet’ with ‘statement of financial position’.

[†] IAS 1 (revised 2007) requires an entity to present all income and expense items in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

- BC213 Some respondents argued that it is difficult to disclose meaningful information about changes in interdependent assumptions. As a result, an analysis by sources of change often depends on the order in which the analysis is performed. To acknowledge this difficulty, the IFRS does not specify a rigid format or contents for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for the risks they face and the systems that they have, or can enhance at a reasonable cost.

Changes in insurance liabilities

- BC214 Paragraph 37(e) of the IFRS requires a reconciliation of changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs. IAS 37 requires broadly comparable disclosure of changes in provisions, but the scope of IAS 37 excludes insurance contracts. Disclosure about changes in deferred acquisition costs is important because some existing methods use adjustments to deferred acquisition costs as a means of recognising some effects of remeasuring the future cash flows from an insurance contract (for example, to reflect the result of a liability adequacy test).

Nature and extent of risks arising from insurance contracts

- BC215 The second disclosure principle in the IFRS requires disclosure of information that enables users of ~~its financial statements~~ to understand the nature and extent of risks arising from insurance contracts (paragraph 38 of the IFRS). The Implementation Guidance supporting this principle builds largely on existing requirements in IFRSs, particularly the disclosures for financial instruments in IFRS 7.
- BC216 Some respondents read the draft Implementation Guidance accompanying ED 5 as implying that the IFRS would require disclosures of estimated cash flows. That was not the Board's intention because insurers cannot be expected to have systems to prepare detailed estimates of cash flows in phase I (beyond what is needed for the liability adequacy test). The Board revised the Implementation Guidance to emphasise that the second disclosure principle requires disclosure **about** cash flows (ie disclosure that helps users understand their amount, timing and uncertainty), not disclosure **of** cash flows.*

Insurance risk

- BC217 For insurance risk (paragraph 39(c)), the disclosures are intended to be consistent with the spirit of the disclosures required by IAS 32[†].[‡] The usefulness of particular disclosures about insurance risk depends on the circumstances of a particular insurer. Therefore, the requirements are written in general terms to allow practice in this area to evolve.

Sensitivity analysis

- BC218 Paragraph 39(c)(i) requires disclosure of a sensitivity analysis. The Board decided not to include specific requirements that may not be appropriate in every case and could impede the development of more useful forms of disclosure or become obsolete.

* IFRS 7 replaced the required disclosures about cash flows with required disclosures about the nature and extent of risks.

[‡] ~~In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.~~

[†] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

- BC219 IAS 32 requires disclosure of a sensitivity analysis only for assumptions that are not supported by observable market prices or rates. However, because the IFRS does not require a specific method of accounting for embedded options and guarantees, including some that are partly dependent on observable market prices or rates, paragraph 39(c)(i) requires a sensitivity analysis for all variables that have a material effect, including variables that are observable market prices or rates.

Claims development

- BC220 Paragraph 39(c)(iii) requires disclosure about claims development. The US Securities and Exchange Commission requires property and casualty insurers to provide a table showing the development of provisions for unpaid claims and claim adjustment expenses for the previous ten years, if the provisions exceed 50 per cent of equity. The Board noted that the period of ten years is arbitrary and decided instead to set the period covered by this disclosure by reference to the length of the claims settlement cycle. Therefore, the IFRS requires that the disclosure should go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years (subject to transitional exemptions in paragraph 44 of the IFRS). Furthermore, the proposal applies to all insurers, not only to property and casualty insurers. However, because an insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year, it is unlikely that many life insurers would need to give this disclosure.
- BC221 In the US, disclosure of claims development is generally presented in management's discussion and analysis, rather than in the financial statements. However, this disclosure is important because it gives users insights into the uncertainty surrounding estimates about future claims, and also indicates whether a particular insurer has tended to overestimate or underestimate ultimate payments. Therefore, the IFRS requires it in the financial statements.

Probable maximum loss

- BC222 Some suggested that an insurer—particularly a general insurer—should disclose the probable maximum loss (PML) that it would expect if a reasonably extreme event occurred. For example, an insurer might disclose the loss that it would suffer from a severe earthquake of the kind that would be expected to recur every one hundred years, on average. However, given the lack of a widely agreed definition of PML, the Board concluded that it is not feasible to require disclosure of PML or similar measures.

Exposures to interest rate risk or market risk

- BC223 As discussed in paragraphs BC193 and BC194, the Board confirmed that an insurer need not account at fair value for embedded derivatives that meet the definition of an insurance contract, but also create material exposures to interest rate risk or market risk. For many insurers, these exposures can be large. Therefore, paragraph 39(e) of the IFRS specifically requires disclosures about these exposures.

Fair value of insurance liabilities and insurance assets

BC224 ED 5 proposed that an insurer should disclose the fair value of its insurance liabilities and insurance assets. This proposal was intended (a) to give useful information to users of an insurer's financial statements and (b) to encourage insurers to begin work on systems that use updated information, to minimise the transition period for phase II.

BC225 Some respondents supported the proposed disclosure of fair value, arguing that it is important information for users. Some felt that this would be particularly important given the range of measurement practices in phase I. However, many respondents (including some who supported a fair value disclosure requirement in principle) suggested that the Board should delete this requirement or suspend it until phase II is completed. They offered the following arguments:

- (a) Requiring such disclosure would be premature before the Board resolves significant issues about fair value measurement and gives adequate guidance on how to determine fair value.* The lack of guidance would lead to lack of comparability for users, place unreasonable demands on preparers and pose problems of auditability. Furthermore, disclosure cannot rectify that lack of comparability because it is difficult to describe the features of different models clearly and concisely.
- (b) Disclosure by 2006 (as proposed in ED 5) would be impracticable because insurers would not have time to create and test the necessary systems.
- (c) Expecting insurers to begin work on an unknown objective would be costly and waste time. Furthermore, in the absence of agreed methods for developing fair value, the systems developed for phase I disclosures of fair value might need changes for phase II.
- (d) The proposal asked for a mandate for the IASB to interpret its own requirement before explaining what it means.

BC226 The Board did not view the proposed requirement to disclose fair value as conditional on the measurement model for phase II. In the Board's view, disclosure of the fair value of insurance liabilities and insurance assets would provide relevant and reliable information for users even if phase II does not result in a fair value model. However, the Board agreed with respondents that requiring disclosure of fair value would not be appropriate at this stage.

Disclosures about the temporary exemption from IFRS 9 and the overlay approach

BC226A In September 2016, the Board issued *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)* to address concerns arising from the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. Paragraphs BC239 and BC269–BC273 discuss the additional disclosures that an insurer is required to provide if it applies those amendments.

* IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

Summary of changes from ED 5

BC227 The following is a summary of the main changes from ED 5 to the IFRS. The Board:

- (a) clarified aspects of the definition of an insurance contract (paragraphs BC36 and BC37).
- (b) clarified the requirement to unbundle deposit components in some (limited) circumstances (paragraphs BC40-BC54).
- (c) deleted the 'sunset clause' proposed in ED 5 (paragraphs BC84 and BC85).
- (d) clarified the need to consider embedded options and guarantees in a liability adequacy test (paragraph BC99) and clarified the level of aggregation for the liability adequacy test (paragraph BC100).
- (e) replaced the impairment test for reinsurance assets. Instead of referring to IAS 36 (which contained no scope exclusion for reinsurance assets before the Board issued IFRS 4), the test will refer to IAS 39 (paragraphs BC107 and BC108).
- (f) deleted the proposed ban on recognising a gain at inception of a reinsurance contract, and replaced this with a disclosure requirement (paragraphs BC109-BC114).
- (g) clarified the treatment of acquisition costs for contracts that involve the provision of investment management services (paragraphs BC118 and BC119).
- (h) changed the prohibition on introducing asset-based discount rates into a rebuttable presumption (paragraphs BC134-BC144).
- (i) clarified aspects of the treatment of discretionary participation features (paragraphs BC154-BC165) and created an explicit new exemption from the requirement to separate, and measure at fair value, some options to surrender a contract with a discretionary participation feature (paragraph 9 of the IFRS).
- (j) introduced an option for an insurer to change its accounting policies so that it remeasures designated insurance liabilities in each period for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require (paragraphs BC174-BC177).
- (k) amended IAS 40 to permit two separate elections for investment property when an entity selects the fair value model or the cost model. One election is for investment property backing contracts that pay a return linked directly to the fair value of, or returns from, that investment property. The other election is for all other investment property (paragraph BC178).
- (l) clarified the applicability of shadow accounting (paragraphs BC181-BC184).
- (m) clarified that an embedded derivative is closely related to the host insurance contract if they are so interdependent that an entity cannot measure the

embedded derivative separately (ie without considering the host contract) (paragraph BC193).

- (n) clarified that the Implementation Guidance does not impose new disclosure requirements (paragraph BC204).
- (o) deleted the proposed requirement to disclose the fair value of insurance contracts from 2006 (paragraphs BC224-BC226).
- (p) provided an exemption from applying most disclosure requirements for insurance contracts to comparatives that relate to 2004 (paragraphs 42-44 of the IFRS).
- (q) confirmed that unit-denominated payments can be measured at current unit values, for both insurance contracts and investment contracts, avoiding the apparent need to separate an 'embedded derivative' (paragraph AG33(g) of IAS 39, inserted by of the IFRS).

Applying IFRS 9 with IFRS 4

Background

BC228 In July 2014, the Board issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 and is effective for annual periods beginning on or after 1 January 2018 with early application permitted.

BC229 In late 2015, the Board was at an advanced stage in its project to replace IFRS 4 with a new Standard for insurance contracts but noted that the effective date of that replacement will be after the effective date of IFRS 9. Both IFRS 9 and the forthcoming insurance contracts Standard are expected to result in major accounting changes for most insurers.^α Some interested parties expressed concern that there could be undesirable consequences, such as additional accounting mismatches and volatility in profit or loss, when IFRS 9 is applied before the forthcoming insurance contracts Standard. The Board agreed that these concerns should be addressed.

BC230 Accordingly, in September 2016 the Board amended IFRS 4 by issuing *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Amendments to IFRS 4), which confirmed with modifications the proposals in the Exposure Draft published in December 2015 (the 2015 ED). The Amendments to IFRS 4 introduce:

- (a) an optional overlay approach that permits insurers to reclassify between profit or loss and other comprehensive income (OCI) an amount equal to the difference between the amount reported in profit or loss for designated financial assets applying IFRS 9 and the amount that would have been reported in profit or loss for those assets if the insurer had applied IAS 39 (paragraphs BC237–BC247); and

^α All references in paragraphs BC228–BC299 to an insurer shall be read as also referring to an issuer of a financial instrument that contains a discretionary participation feature.

- (b) an optional temporary exemption from IFRS 9 for insurers whose activities are predominantly connected with insurance (paragraphs BC248-BC277).^β

BC231 Although creating options within IFRSs can reduce comparability, the Board made both the overlay approach and the temporary exemption from IFRS 9 optional. This permits insurers that are eligible for the temporary exemption from IFRS 9 or the overlay approach to choose not to apply them and instead apply the improved accounting requirements in IFRS 9 without adjustment. Comparability is discussed further in paragraphs BC288—BC289.

BC232 Some interested parties suggested that the Board should permit all insurers to defer the application of IFRS 9. They expressed concern that two sets of major accounting changes in a short period of time could result in significant cost and effort for preparers and users of financial statements and also expressed the view that applying IFRS 9 before the effects of the forthcoming insurance contracts Standard can be fully evaluated would require insurers to ‘apply IFRS 9 twice’.

BC233 However, the Board decided that the temporary exemption from IFRS 9 should not be available for all insurers but rather should be limited to insurers that are significantly affected by the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. The Board concluded that for other insurers the disadvantages of the temporary exemption would outweigh the advantages. In particular, the Board noted that IFRS 9 introduces significant improvements in accounting for financial instruments that should be implemented promptly. These improvements are particularly important for insurers because they hold significant investments in financial instruments. In fact, most users of financial statements with whom the Board and staff held discussions supported the application of IFRS 9 on its effective date because it would result in significantly improved information about insurers’ financial instruments. As a result, most users of financial statements preferred the overlay approach over the temporary exemption.

BC234 The Board also observed that there are differing views on whether applying these two sets of major accounting changes consecutively in a short period of time, rather than simultaneously, would result in significant incremental costs for preparers. The Board concluded that the incremental costs for preparers of applying IFRS 9 before applying the forthcoming insurance contracts Standard when compared to applying both Standards at the same time would be limited. This is because all insurers will ultimately have to apply both Standards and incur the costs necessary to do so.

BC235 The Board noted that the concerns about having to ‘apply IFRS 9 twice’ seem to arise from the Board’s decision to provide transition reliefs on initial application of the forthcoming insurance contracts Standard for those insurers that have previously applied IFRS 9. Those transition reliefs would permit, but not require, an insurer to reassess the business model for financial assets and designate or de-designate financial assets under the fair value option and the OCI presentation election for investments in equity instruments based on the facts and circumstances that exist on the date of transition to the forthcoming insurance contracts Standard. The Board observed that the incremental costs of applying those reliefs would be limited because they are optional rather than mandatory and, if applied, would affect only particular financial assets.

^β— For the avoidance of doubt, any reference to IFRS 9 includes all of its appendices. For example, Appendix C of IFRS 9 specifies amendments to other IFRSs that apply when an entity applies IFRS 9. Those amendments do not apply when an entity applies the temporary exemption from IFRS 9, except as necessary to provide the disclosures required by the Amendments to IFRS 4.

BC236 In addition, the Board noted that insurers applying IFRS 9 with IFRS 4 would be able to address concerns about additional accounting mismatches and volatility in profit or loss by using the existing accounting options in IFRS 4 until the forthcoming insurance contracts Standard is applied. In particular, in such circumstances, IFRS 4 permits shadow accounting (see paragraph 30 of IFRS 4), the use of current market interest rates in the measurement of insurance contracts (see paragraph 24 of IFRS 4) and changes in an insurer's accounting policies for insurance contracts (see paragraph 22 of IFRS 4).

Overlay approach

BC237 An insurer applying the overlay approach applies IFRS 9, and consequently provides:

- (a) the significantly improved information about financial instruments that results from applying IFRS 9, in particular information on credit risk, that will enable improved analysis by users of financial statements; and
- (b) information about financial instruments that is comparable to the information provided by entities that apply IFRS 9 without the overlay approach.

BC238 Furthermore, the overlay approach provides additional information to users of financial statements that will enable them to understand the effects of applying IFRS 9 to the designated financial assets. Applying the overlay approach, an insurer adjusts profit or loss for the designated financial assets so that it reports the same overall amount that it would have reported in profit or loss if IAS 39 had been applied to those financial assets. However, because the insurer makes an offsetting adjustment to OCI, total comprehensive income is not affected (ie total comprehensive income is the same as applying IFRS 9 without the overlay approach). The carrying amounts of all financial assets are determined applying IFRS 9.

BC239 The adjustment to profit or loss for the designated financial assets addresses the additional accounting mismatches and volatility in profit or loss that may arise from applying IFRS 9 before applying the forthcoming insurance contracts Standard. The accompanying presentation and disclosure requirements make the effect of the overlay adjustment transparent.

Eligibility for the overlay approach

BC240 The overlay approach is intended to address the additional accounting mismatches and volatility in profit or loss that may arise if an insurer applies IFRS 9 before applying the forthcoming insurance contracts Standard. To meet that objective:

- (a) an insurer may elect to apply the overlay approach only when it first applies IFRS 9;^φ and
- (b) a financial asset is eligible for designation if, and only if, it meets both of the following criteria:

^φ— This includes applying the overlay approach after previously applying either the temporary exemption from IFRS 9 or only the requirements in IFRS 9 for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss (the 'own credit' requirements).

- (i) it is measured at fair value through profit or loss (FVPL) applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39. This criterion limits application of the overlay approach to those financial assets for which the application of IFRS 9 may result in additional volatility in profit or loss. An example is a financial asset that is measured at FVPL applying IFRS 9 but that would have been bifurcated into a derivative and a host applying IAS 39.
- (ii) it is not held in respect of an activity that is unconnected with contracts within the scope of IFRS 4. The forthcoming insurance contracts Standard will not affect assets held in respect of an activity that is unconnected with contracts within the scope of IFRS 4. For example, financial assets held in respect of banking activities or financial assets held in funds relating to investment contracts that are outside the scope of IFRS 4 would not be eligible for designation. On the other hand, financial assets held for insurance regulatory requirements (or for internal capital objectives for the insurance business) are eligible because the forthcoming insurance contracts Standard may affect them.

BC241 Insurers may choose whether to apply the overlay approach, and to what extent. The availability of such a choice reduces comparability among insurers. However, the Board decided not to require insurers to apply the overlay approach to all eligible financial assets. That is because there is no loss of information when an insurer applies the overlay approach to only some financial assets. As described in paragraphs BC238 and BC243, when an insurer applies the overlay approach, it applies IFRS 9 to all its financial assets and provides additional information about the designated financial assets. Moreover, not requiring an insurer to designate all eligible financial assets minimises the cost of applying the overlay approach and permits insurers to decide how broadly to apply it. Insurers may have different approaches to designating eligible financial assets depending on the extent of, and the insurers' desire to address, the additional accounting mismatches and volatility in profit or loss that may arise from the financial assets they hold.

BC242 Finally, the Board considered the risk that an insurer could apply the overlay approach selectively with the intention of managing reported profit or loss. However, the following features of the overlay approach mitigate this risk:

- (a) IFRS 9 is applied to designated financial assets, consistently with financial assets that are not designated, and the accompanying presentation and disclosure requirements make the effect of applying the overlay approach transparent.
- (b) an insurer may elect to apply the overlay approach only when it first applies IFRS 9.
- (c) an insurer must continue to apply the overlay approach to a designated financial asset until the asset is derecognised, unless the financial asset no longer meets the eligibility criterion described in paragraph BC240(b)(ii) or the insurer stops applying the overlay approach to all designated financial assets. Disclosures are required when an insurer changes its designation of financial assets to make such changes transparent.

- (d) when an entity no longer has contracts within the scope of IFRS 4, it must stop applying the overlay approach and cannot recommence applying it.

Presentation

- BC243 IFRS 9 must be applied to measure designated financial assets and the income and expense presented in profit or loss for those assets must reflect the application of that Standard. The amount reclassified between profit or loss and OCI (the overlay adjustment) is presented as a separate line item in profit or loss and in OCI, separately from other components in OCI. These presentation requirements are intended to make the overlay adjustment transparent, improve comparability with entities applying IFRS 9 without the overlay approach, and provide users of financial statements with information about the effect on an insurer's financial results of applying IFRS 9 to designated financial assets before the forthcoming insurance contracts Standard.
- BC244 The Board decided not to provide additional presentation guidance for the overlay adjustment and instead decided to rely on the requirements in IAS 1 for the presentation of line items in the statement of comprehensive income. Applying IAS 1, the overlay adjustment will be grouped in OCI with other items that will be reclassified subsequently to profit or loss. Additionally, applying IAS 1, line items in profit or loss are presented pre-tax unless otherwise specified. Therefore, the overlay adjustment is presented in profit or loss on a pre-tax basis.

Interaction with other requirements

- BC245 The Board observed that reclassifying an amount between profit or loss and OCI applying the overlay approach may have consequential effects for including other items in OCI, such as income taxes. The Board decided that it was unnecessary to develop specific requirements for those consequential effects because other IFRSs, such as IAS 12 *Income Taxes*, contain the relevant requirements.
- BC246 When an insurer applies the overlay approach, shadow accounting may be applicable if, and only if, the designated financial assets have a direct effect on the measurement of some or all of its insurance liabilities, related deferred acquisition costs and related intangible assets (see paragraph 30 of IFRS 4). The Board observed that applying both the overlay approach and shadow accounting enables an insurer to report the same profit or loss as if it had applied IAS 39 to the designated financial assets. At the same time, the overall effect on total comprehensive income reflects the result of applying IFRS 9 to those assets.

Transition

- BC247 An insurer can apply the overlay approach only when it applies IFRS 9. As a result, the approach to transition and comparative information for the overlay approach is consistent with the approach in IFRS 9. IFRS 9 requires an entity to apply IFRS 9 retrospectively, subject to specified transition reliefs. Accordingly, the insurer must also apply the overlay approach retrospectively. IFRS 9 permits an entity to restate comparative information on transition to IFRS 9, except in specified circumstances in which restatement is prohibited. Accordingly, the insurer is required to restate comparative information to reflect the overlay approach when that comparative information is restated applying IFRS 9, but otherwise is prohibited from doing so.

Temporary exemption from IFRS 9

BC248 The Board observed that although the overlay approach addressed concerns about the additional accounting mismatches and volatility in profit or loss that may arise when IFRS 9 is applied in conjunction with IFRS 4, it would result in additional costs compared to applying IFRS 9 without the overlay approach (see paragraph BC294) or allowing insurers to continue to apply IAS 39.

BC249 Accordingly, the Board introduced a temporary exemption from IFRS 9 for a limited period for insurers whose activities are predominantly connected with insurance. An insurer applying the temporary exemption continues to apply IAS 39 rather than applying IFRS 9. The Board concluded that, for such insurers in that limited period, the temporary exemption reduces costs in a way that would outweigh the following disadvantages:

- (a) users of financial statements would not have the significantly improved information about financial instruments provided by applying IFRS 9; and
- (b) cross-sector comparability would be reduced.

BC250 The Board decided that the temporary exemption from IFRS 9 should not be available to insurers whose activities are not predominantly connected with insurance because the disadvantages for users of financial statements would outweigh the benefits for those insurers of applying the temporary exemption.

Eligibility for the temporary exemption

BC251 An insurer may apply the temporary exemption from IFRS 9 if, and only if:

- (a) it has not previously applied IFRS 9^ψ (see paragraph BC253); and
- (b) its activities are predominantly connected with insurance, which is assessed on the basis of the following two criteria:
 - (i) the insurer has a significant amount of liabilities arising from contracts within the scope of IFRS 4 (see paragraph BC258); and
 - (ii) the percentage of the insurer's liabilities connected with insurance relative to all its liabilities meets a specified threshold (see paragraphs BC254–BC257).

BC252 Insurers must assess their eligibility for the temporary exemption from IFRS 9 at the reporting entity level. That is, an entity as a whole is assessed by considering all its activities. As a result, an insurer applies either IAS 39 or IFRS 9 to all its financial assets and financial liabilities (see paragraphs BC260–BC263).

^ψ —However, an entity that has applied only the requirements in IFRS 9 for the presentation of gains and losses on financial liabilities designated as at FVPL (the 'own credit' requirements) is not precluded from applying the temporary exemption from IFRS 9. If an entity applies those own credit requirements, it must apply the relevant requirements in IFRS 7 (as amended by IFRS 9 (2010)).

Qualifying criteria

BC253 The Board decided that an insurer that has previously applied IFRS 9 is not permitted to apply the temporary exemption from IFRS 9. This is because:

- (a) applying the temporary exemption after applying IFRS 9 would disrupt trend information several times (ie on transition to IFRS 9, followed by transition back into IAS 39, followed by another transition to IFRS 9 when the insurer applies the forthcoming insurance contracts Standard); and
- (b) if the insurer has already applied IFRS 9, it will have explained the effects of that application to the users of its financial statements, and the temporary exemption would not reduce the costs of applying IFRS 9 before applying the forthcoming insurance contracts Standard.

BC254 In the 2015 ED, the Board proposed that an insurer that has not yet applied IFRS 9 would be eligible for the temporary exemption from IFRS 9 only if its predominant activity is issuing contracts within the scope of IFRS 4. Under those proposals, an insurer would have made that determination by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 to the total carrying amount of all its liabilities.

BC255 However, in the light of the feedback received on the 2015 ED, particularly from some users of financial statements, the Board broadened the qualifying criteria for the temporary exemption from IFRS 9 in order to improve comparability among peers in the insurance sector. Specifically, in addition to the liabilities arising from contracts within the scope of IFRS 4, the Board decided to treat the following liabilities as being connected with insurance for the purposes of assessing whether an insurer's activities are predominantly connected with insurance:

- (a) non-derivative investment contract liabilities measured at FVPL applying IAS 39 (including those designated as at FVPL to which the insurer has applied the requirements in IFRS 9 for the presentation of gains and losses). Even though they do not meet the definition of an insurance contract applying IFRS 4, the Board noted that those investment contracts are sold alongside similar products with significant insurance risk and are regulated as insurance contracts in many jurisdictions. Also, such investment contracts are generally measured at FVPL. Accordingly, the Board concluded that insurers with significant investment contracts measured at FVPL should not be precluded from qualifying for the temporary exemption. However, the Board noted that insurers generally measure at amortised cost most non-derivative financial liabilities that are associated with non-insurance activities and therefore decided that such financial liabilities cannot be treated as connected with insurance.
- (b) liabilities that arise because the insurer issues, or fulfils its obligations arising from: (i) contracts within the scope of IFRS 4 and (ii) non-derivative investment contracts measured at FVPL. The Board noted that even if an insurer undertakes only insurance activities, other connected liabilities may arise, such as liabilities for salaries and other employment benefits for the employees of the insurance activities. Accordingly, the Board decided that these other liabilities should be treated as being connected with insurance for the purposes of assessing an insurer's predominant activities.

BC256 To avoid ambiguity and undue effort in determining eligibility for the temporary exemption from IFRS 9, particularly because it is available only for a limited period and is an exemption from the requirements that otherwise must be applied to financial instruments, the Board concluded that it was important to clearly identify the targeted population. Accordingly, the Board decided that there should be a threshold that determines when an insurer's activities are considered to be predominantly connected with insurance. That determinative threshold is met when the percentage of the total carrying amount of an insurer's liabilities connected with insurance relative to the total carrying amount of all its liabilities is greater than 90 per cent. Nevertheless, the Board acknowledged that an assessment based solely on this threshold has shortcomings. Accordingly, the Board decided that when an insurer narrowly fails to meet the threshold, the insurer is still able to qualify for the temporary exemption as long as more than 80 per cent of its liabilities are connected with insurance, and it does not engage in a significant activity unconnected with insurance.

BC257 The Board considered that an insurer with one or more significant activities unconnected with insurance is comparable to other conglomerates, and is less likely to be comparable to entities that are regarded purely as 'insurers'. For insurers engaged in significant activities unconnected with insurance, the Board decided that the benefits for users of financial statements of comparability with non-insurance entities outweigh the benefits of the temporary exemption from IFRS 9. To achieve an appropriate balance between clearly identifying those insurers that qualify for the temporary exemption and creating 'bright lines', the Board concluded that the insurer should consider both quantitative and qualitative factors to determine whether it has a significant activity unconnected with insurance.

BC258 The Board emphasised that its objective is to provide the temporary exemption from IFRS 9 only to insurers significantly affected by the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. That objective is met only if the insurer has a significant amount of liabilities arising from contracts within the scope of IFRS 4. Accordingly, the Board decided that, to qualify for the temporary exemption, the carrying amount of an insurer's liabilities arising from contracts within the scope of IFRS 4 must be significant compared to the total carrying amount of all its liabilities. Otherwise, applying only the criterion discussed in paragraphs BC251(b)(ii) and BC255, an insurer could qualify for the temporary exemption even if, for example, it had very few contracts within the scope of IFRS 4. The Board acknowledged that determining 'significance' will require judgement but decided not to provide additional guidance on its meaning because this term is used in other IFRSs and is already applied in practice.

BC259 The Board also clarified that deposit components and embedded derivatives that an insurer unbundles from insurance contracts applying paragraphs 7–12 of IFRS 4, and accounts for using IAS 39, are considered liabilities arising from contracts within the scope of IFRS 4 for the purposes of assessing eligibility for the temporary exemption from IFRS 9.

Assessment at the reporting entity level

BC260 The Board concluded that a reporting entity would provide more understandable and useful information by accounting for its financial assets and financial liabilities applying either IFRS 9 or IAS 39 (ie if the temporary exemption from IFRS 9 applies at the reporting entity level). This is the primary reason why the Board decided that the temporary exemption from IFRS 9 should be available only if the entity as a whole qualifies by considering all of its activities. In considering the feedback on the

2015 ED, the Board discussed suggestions from some respondents that the eligibility for the temporary exemption should be assessed both at and below the reporting entity level. The following views were expressed in support of that approach:

- (a) some respondents stated that users of financial statements do not rely on the information in a group's consolidated primary financial statements for sector comparisons of conglomerates and instead focus on other types of information (eg segmental information). Therefore, in those respondents' view, consolidated financial statements that include both IFRS 9 and IAS 39 information would not cause difficulties for many users of financial statements.
- (b) some respondents argued that avoiding the additional costs of applying IFRS 9 before applying the forthcoming insurance contracts Standard is as important for the insurance activities within a diversified group as it is for a group in its entirety.

BC261 However, the Board rejected the suggestion to permit insurers to apply the temporary exemption from IFRS 9 below the reporting entity level. The Board noted that:

- (a) IFRSs require a reporting entity to use consistent accounting policies because this enables users of financial statements to compare the reporting entity with other reporting entities, and provides more understandable and useful information about the reporting entity's assets and liabilities. Consistent accounting policies also reduce accounting complexities arising from intra-group transactions. Conglomerates that engage in both insurance and non-insurance activities frequently have complex corporate and financial structures, and engage in complex transactions. Any requirement or option to split these entities into constituent parts would necessarily be complex in order to encompass all possible structures and activities—both complex to articulate and complex for users of financial statements to understand.
- (b) most users of financial statements and regulators supported assessing eligibility for the temporary exemption from IFRS 9 at the reporting entity level. This is because they were concerned about the implications of applying the temporary exemption below the reporting entity level—specifically, applying both IFRS 9 and IAS 39 in one set of consolidated financial statements. They stated that such an approach would make financial statements more complex to understand and compare. Users of financial statements told the Board that understanding how IAS 39 and IFRS 9 are applied to different parts of an entity and analysing two significant changes in the accounting for financial instruments in a short period of time (ie the changes arising from initially applying IFRS 9 to only some parts of a reporting entity and then the changes arising from subsequently applying IFRS 9 to the rest of its activities) would be more confusing compared to an entity continuing to apply IAS 39 or applying IFRS 9.

BC262 Nonetheless, the Board observed that if a group fails to qualify for the temporary exemption from IFRS 9 because its activities are not predominately connected with insurance, then the group could provide additional information to explain more clearly the effects of applying IFRS 9 with IFRS 4. In particular, although the group would apply IFRS 9 to all financial assets and financial liabilities reported in its consolidated financial statements:

- (a) the overlay approach would be available to address additional accounting mismatches and volatility in profit or loss associated with the group's insurance activities arising from the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard.
- (b) the group would have had to disclose segmental information in accordance with IFRS 8 *Operating Segments* for its insurance activities using IAS 39, if such information is used in internal management reports and if insurance activities are an operating segment. Even if the group did not produce such segmental information, the group could still choose to disclose additional information for its insurance activities using IAS 39. This would facilitate comparisons with other insurers applying IAS 39.

BC263 In addition, if an individual reporting entity, such as a subsidiary, undertakes activities predominantly connected with insurance, and prepares separate or individual financial statements, it could apply the temporary exemption from IFRS 9 in those separate or individual financial statements, even though it is required to produce information using IFRS 9 for inclusion in the consolidated financial statements. That subsidiary may decide that the cost of applying the temporary exemption (ie IAS 39) in its separate or individual financial statements is justified despite also needing to prepare IFRS 9 information for consolidation.

Initial assessment and reassessment of predominant activities

BC264 The 2015 ED proposed that an entity would assess whether it qualifies for the temporary exemption from IFRS 9 on the date that it would otherwise be required to initially apply IFRS 9; ie the first day of the annual period beginning on or after 1 January 2018. However, respondents told the Board that entities would need to perform the assessment earlier than that proposed date because they would need adequate time to implement IFRS 9 if they did not qualify for the temporary exemption. Therefore, the Board decided that an entity assesses whether its activities are predominantly connected with insurance at its annual reporting date (ie the end of its annual period) that immediately precedes 1 April 2016. This assessment date is intended to reduce uncertainty and provide adequate time for entities to implement IFRS 9 if they do not qualify for the temporary exemption.

BC265 An entity that previously qualified for the temporary exemption from IFRS 9 is required to reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date if, and only if, there was a change in its activities as described in paragraphs 20H–20I of IFRS 4 during the annual period that ended on that date (for example, the acquisition or disposal of a business line). The Board observed that a change in an entity's activities is expected to be very infrequent and provided further guidance on the nature of such changes. The Board considered that a change merely in the level of an entity's insurance liabilities relative to its total liabilities over time would not trigger a reassessment because such a change, in the absence of other events, would be unlikely to indicate a change in the entity's activities.

BC266 The entity's financial statements would reflect the effects of a change in its activities only after the change has been completed. Therefore, an entity performs the reassessment using the carrying amounts of its liabilities at the annual reporting date immediately following the completion of the change in its activities. For example, an entity would reassess whether its activities are predominantly connected with insurance at the annual reporting date immediately following the completion of an acquisition.

BC267 When an entity concludes, as a result of a reassessment, that its activities are no longer predominantly connected with insurance, the entity is permitted to continue to apply the temporary exemption from IFRS 9 only until the end of the annual period that began immediately after that reassessment. Nevertheless, the entity must apply IFRS 9 in annual periods beginning on or after 1 January 2021, which is the fixed expiry date of the temporary exemption. The Board concluded that this provides entities with time to implement IFRS 9 after a change in their activities. But all entities must apply IFRS 9 by the fixed expiry date of the temporary exemption, and a change in their activities would not affect the preparations needed to implement IFRS 9 by that date.

BC268 Similarly, an entity that previously did not qualify for the temporary exemption from IFRS 9 and has not applied IFRS 9 is permitted to reassess its eligibility at a subsequent reporting date before 31 December 2018 (the effective date of IFRS 9) if, and only if, there was a change in the entity's activities as described in paragraphs 20H–20I of IFRS 4. The Board concluded that this provision, which was not included in the 2015 ED, was appropriate as a result of its decision to set an earlier initial assessment date than was proposed in that ED (see paragraph BC264).

Disclosure

BC269 The temporary exemption from IFRS 9 will delay the provision of better information by some insurers and reduce comparability among insurers and between insurers and other entities. To mitigate these disadvantages, the Board decided that an insurer applying the temporary exemption must disclose information to enable users of financial statements to make some comparisons between insurers applying the temporary exemption and entities applying IFRS 9.

BC270 In requiring these disclosures, the Board was conscious of the need to minimise the extent to which an insurer would need to prejudge considerations that it will make when it later applies IFRS 9. The Board also noted that disclosures based on the assessment of the business model applying IFRS 9 or disclosures that would effectively require an insurer to apply the IFRS 9 impairment requirements would be unduly burdensome for preparers, though some users of financial statements had suggested that such disclosures would be useful.

BC271 In response to the 2015 ED, most regulators and users of financial statements supported the disclosure objectives proposed by the Board. They also suggested that the Board require additional disclosures to assist in cross-sector comparisons and in better understanding the credit risk of financial assets held by insurers applying the temporary exemption from IFRS 9. In contrast, some preparers expressed the view that the Board should not require disclosures that would require insurers applying the temporary exemption to apply any aspect of IFRS 9.

BC272 The Board concluded that it could balance the potential cost for preparers with improved comparability for users of financial statements and regulators by requiring:

- (a) fair value information for all financial assets, separated into groups that would identify a population that is similar to the population that would be separately disclosed as mandatorily measured at FVPL applying IFRS 9; and
- (b) credit risk information for a specific population of financial assets that is similar to the population to which the IFRS 9 expected credit loss requirements would apply.

Insurers applying the temporary exemption from IFRS 9 must use the requirements in IFRS 9, including any consequential amendments that IFRS 9 made to other IFRSs (such as IFRS 7), that are necessary to provide those disclosures.

BC273 Paragraph 30 of IAS 8 requires an entity to disclose information when it has not applied a new IFRS that has been issued but is not yet effective. Accordingly, the Board observed that insurers are required to provide information about the expected effect of the Amendments to IFRS 4 before they are effective, including whether the insurer expects to apply the temporary exemption from IFRS 9.

Transition

BC274 The Board noted that no special transition provisions are needed for the temporary exemption from IFRS 9. This is because, when an insurer first applies:

- (a) the temporary exemption, it would continue applying IAS 39 and start providing the disclosures required by the Amendments to IFRS 4, using the relevant provisions in IFRS 9 that are necessary to provide those disclosures; and
- (b) IFRS 9 after previously applying the temporary exemption, it would apply the transition requirements in IFRS 9 and stop providing the required disclosures relating to the temporary exemption.

Fixed expiry date for the temporary exemption

BC275 The forthcoming insurance contract Standard will replace IFRS 4 and therefore, the temporary exemption from IFRS 9 will no longer exist when the insurer first applies that forthcoming Standard. However, the Board decided that, even if the forthcoming insurance contract Standard is not effective by 1 January 2021, all insurers must apply IFRS 9 for annual periods beginning on or after 1 January 2021.

BC276 The Board considered the view that an insurer should be required to apply IFRS 9 only when it applies the forthcoming insurance contracts Standard. However, the Board disagreed with that view because IFRS 9 provides significant improvements to the accounting requirements for financial instruments. Hence, the Board decided that a temporary exemption from IFRS 9 would be acceptable only if it is in place for a short period of time. Therefore, insurers are required to apply IFRS 9 no later than 2021.

BC277 In contrast, the Board rejected a fixed expiry date for the overlay approach. Unlike insurers applying the temporary exemption from IFRS 9, insurers applying the overlay approach will provide the improved financial instrument information required by IFRS 9 and information about the effects on designated assets of moving from IAS 39 to IFRS 9. Accordingly, the rationale set out in paragraph BC276 for setting a fixed expiry date for the temporary exemption does not apply to the overlay approach. However, the forthcoming insurance contract Standard will replace IFRS 4 and therefore, the overlay approach in IFRS 4 will no longer exist when the insurer first applies that forthcoming Standard.

Temporary exemption from specific requirements in IAS 28

BC278 When an entity applies the equity method, paragraphs 35—36 of IAS 28 *Investments in Associates and Joint Ventures* require the entity to adjust its associate's or joint venture's accounting policies to conform them to the entity's accounting policies.

The 2015 ED did not propose any relief from this requirement. However, in the light of the feedback received, the Board decided that:

- (a) an entity that applies IFRS 9 would be permitted, but not required, to retain the IAS 39 accounting used by any associate or joint venture that applies the temporary exemption from IFRS 9 in its financial statements;
- (b) an entity that applies the temporary exemption from IFRS 9 would be permitted, but not required, to retain the IFRS 9 accounting used by any associate or joint venture in its financial statements; and
- (c) these reliefs would be available separately for each associate or joint venture.

BC279 These reliefs are intended to reduce the costs of applying the equity method when an entity does not qualify for the temporary exemption from IFRS 9, and thus applies IFRS 9, but one or more of the entity's associates or joint ventures is eligible and chooses to continue to apply IAS 39 (or vice versa).

BC280 The Board observed that when providing these reliefs, cost and benefit considerations for accounting for associates and joint ventures using the equity method are different to those for subsidiaries that are consolidated, for the following reasons:

- (a) users of financial statements lose less information when entities apply equity accounting using different accounting policies for similar transactions than when entities prepare consolidated financial statements using different accounting policies for similar transactions. Under the equity method, the assets and liabilities of the associate and joint venture are not controlled by the entity and therefore are not considered as part of the group. Accordingly, the reliefs affect only the net amounts recognised through the equity method instead of all the items related to financial instruments presented in the group's financial statements.
- (b) significant additional practical difficulties or costs may arise for an entity to apply uniform accounting policies when equity accounting is applied compared to when preparing consolidated financial statements because the entity does not control an associate or joint venture.

BC281 The Board concluded that similar reliefs are not needed for the overlay approach because that approach is applied on an instrument-by-instrument basis—that is, an entity need not apply the overlay approach to all eligible financial assets. Accordingly, when applying the equity method, the entity could retain (or modify) the overlay approach applied by an associate or joint venture or retain the associate's or joint venture's full IFRS 9 accounting.

First-time adopter

BC282 The Board decided that the concerns raised by some interested parties about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard could be equally applicable to some first-time adopters. This might be the case, for example, when a first-time adopter previously applied accounting policies for financial instruments under a national GAAP that was not significantly different from IFRSs. Consequently, the Board decided to permit first-time adopters to apply the overlay approach, described in paragraph 35B of IFRS 4, or the temporary

exemption from IFRS 9, described in paragraph 20A of IFRS 4, consistently with existing IFRS preparers if, and only if, those first-time adopters meet the same criteria. For example, a first-time adopter would assess whether its activities are predominately connected with insurance in the same way, and on the same date, as an existing IFRS preparer.

Effects analysis of Applying IFRS 9 with IFRS 4

BC283 The Board is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing costs and benefits of each new IFRS—the costs and benefits are collectively referred to as ‘effects’. The Board gains insight on the likely effects of the proposals for new or revised IFRSs through its formal exposure of proposals, analysis and consultations with relevant parties.

BC284 In evaluating the likely effects of the Amendments to IFRS 4, the Board has considered the following:

- (a) how the overlay approach and the temporary exemption from IFRS 9 affect the financial statements of those applying IFRS;
- (b) whether the changes improve the comparability of financial information between different reporting periods for an individual entity and among different entities in a particular reporting period;
- (c) whether the changes will improve the ability of users of financial statements to assess the future cash flows of an entity;
- (d) whether the improvements to financial reporting will result in better economic decision-making;
- (e) the likely effect on compliance costs for preparers; and
- (f) whether the likely costs of analysis for users of financial statements are affected.

Financial statements of those applying IFRS

BC285 The Amendments to IFRS 4 would affect only those insurers that have not applied IFRS 9 (other than the requirements for the presentation of gains and losses on financial liabilities designated as at FVPL). Accordingly, non-insurers, or insurers that have already applied IFRS 9, will not be affected by the changes.

BC286 The Amendments to IFRS 4 introduce the overlay approach—the option to reclassify between profit or loss an amount equal to the incremental effect on profit or loss of applying IFRS 9 to designated financial assets until the insurer applies the forthcoming insurance contracts Standard. That approach will affect the financial statements as follows:

- (a) the overlay approach will change the reported profit or loss and total OCI. However, the overlay approach will not change the carrying amounts reported on the statement of financial position, nor will it change total comprehensive income.

- (b) insurers will present a line item for the amount reclassified in the statement of profit or loss, and in OCI separately from other components of OCI.
- (c) insurers will provide disclosures to explain how the overlay adjustment is calculated and the effect of that adjustment on the financial statements.

BC287 The Amendments to IFRS 4 also, as an alternative, permit an insurer meeting specified criteria to apply a temporary exemption from IFRS 9—the option to defer the application of IFRS 9 until the earlier of the date when the insurer applies the forthcoming insurance contracts Standard or the fixed expiry date of the temporary exemption. The temporary exemption from IFRS 9 will affect the financial statements as follows:

- (a) the carrying amounts reported in the statement of financial position and the profit or loss and total comprehensive income reported in the statement of profit or loss and OCI will be different compared to if the insurer had applied IFRS 9. However, there will be no effect on comparability with the insurer's prior period financial statements because the insurer will continue to apply IAS 39.
- (b) insurers applying the temporary exemption will provide disclosures that will enable users of financial statements to make comparisons between entities applying the temporary exemption and entities applying IFRS 9.

Comparability

BC288 The financial statements of insurers that apply the overlay approach or the temporary exemption from IFRS 9 will not be directly comparable with entities that apply IFRS 9. Furthermore, making those two approaches optional also reduces comparability among entities. However, the Board has sought to mitigate the concerns about comparability by deciding the following:

- (a) the effect of the overlay approach must be presented as a separate line item in profit or loss and in OCI, separately from other components of OCI. This will help users of financial statements to compare entities that apply the overlay approach and those that apply IFRS 9 without the overlay approach.
- (b) the scope of the temporary exemption is restricted with the intention that any reduction in comparability affects only peers within the insurance sector. In addition, based on the feedback received, the Board expects that in a particular jurisdiction, insurers that qualify for the temporary exemption would select the same options relating to the overlay approach or the temporary exemption, which would improve comparability in practice within a jurisdiction.
- (c) the disclosure requirements provide some information that will enable users of financial statements to compare entities that apply the temporary exemption with those that apply IFRS 9.
- (d) there is a fixed expiry date for the temporary exemption from IFRS 9. That fixed expiry date, and the Board's commitment to completing the forthcoming insurance contracts Standard expeditiously, mean that any reduction in comparability will last only for a short period of time (ie until the temporary exemption expires or the forthcoming insurance contracts Standard is applied).

- (e) eligibility for the temporary exemption is assessed at the reporting entity level and an entity applies either IAS 39 or IFRS 9 to all its financial assets and financial liabilities. Accordingly, an entity may apply either the temporary exemption or the overlay approach in its financial statements, but not both (except in the limited case of equity accounting as discussed in paragraphs BC278–BC281).

BC289 Nevertheless, the Board acknowledged that *full* comparability cannot be achieved by these decisions because such comparability would be achieved only if all insurers applied IFRS 9 when it becomes effective or if all entities, including insurers, deferred IFRS 9. The Board concluded that deferring the effective date of IFRS 9 for all entities would be a disproportionate response to the issues raised because it would mean that preparers and users of financial statements would not benefit from the better reporting that results from applying IFRS 9.

Usefulness in assessing the future cash flows of an entity and better economic decision-making

BC290 The Board received mixed feedback as to whether the Amendments to IFRS 4 would result in financial statements that are more useful in assessing the cash flows of an insurer:

- (a) many users of financial statements did not support the temporary exemption from IFRS 9 because:
- (i) they expected no additional difficulty in their analysis as a result of the additional accounting mismatches and volatility in profit or loss that might arise if IFRS 9 was applied before the forthcoming insurance contracts Standard; and
 - (ii) they already saw volatility when analysing insurers and were able to make adjustments necessary to understand the financial performance of such insurers.
- (b) however, some users expressed concerns about potential additional volatility in profit or loss and supported the overlay approach, the temporary exemption, or both, because reporting such volatility could:
- (i) make the financial statements of insurers less understandable and less attractive for investment; and
 - (ii) make it more difficult to predict long-term economic performance and to forecast earnings based on profit or loss information.

BC291 The Board expects that the temporary exemption from IFRS 9 would not impair a user's existing ability to assess an insurer's future cash flows because the insurer would continue to apply the existing requirements in IAS 39. However, insurers applying the temporary exemption would not provide users of financial statements with the better information that would be available from entities applying IFRS 9. In addition, the application of the temporary exemption may impair the usefulness of information for economic decision-making because of the reduced comparability among entities. The Board has sought to mitigate the concern about comparability as described in paragraph BC288.

BC292 The Board expects that the overlay approach would provide users of financial statements with better information to assess future cash flows and make economic decisions than would be the case if an insurer applies the temporary exemption from IFRS 9. This is because insurers applying the overlay approach would provide the improved financial instrument information resulting from applying IFRS 9. In addition, insurers applying the overlay approach would provide additional information that would help users of financial statements to understand the effects, on designated financial assets, of applying IFRS 9.

Effect on compliance costs for preparers

BC293 The temporary exemption from IFRS 9 will be more costly for preparers than just applying IAS 39 because of the additional disclosures required. However, the Board does not consider those costs to be unduly onerous because those disclosures do not require the insurer to apply IFRS 9 in its entirety, and in particular, do not require the application of the expected credit loss model in IFRS 9.

BC294 IAS 39 already requires insurers to disclose fair value information for financial assets eligible for designation under the overlay approach and that is the only additional information needed to apply that approach. However, the overlay approach will be more costly than applying:

- (a) only IFRS 9, because an insurer will need to decide which financial assets to designate and will then need to continue to track and measure those designated assets in accordance with IAS 39.
- (b) the temporary exemption from IFRS 9, because an insurer applying the overlay approach will incur costs to apply IFRS 9 earlier than if it applied the temporary exemption. However, all insurers applying the temporary exemption will apply IFRS 9 in the future and thus will incur the necessary costs to do so at that point.

BC295 Nevertheless, the Board noted that the insurers would already have systems in place to measure the designated financial assets in accordance with IAS 39 because the information required to apply the overlay approach is the same as the information previously prepared when the insurer applied IAS 39. Moreover, the Board noted that if an insurer determines that the costs of the overlay approach are excessive, that insurer could choose not to apply the overlay approach or to apply it to only some of its eligible assets.

BC296 Finally, instead of applying the temporary exemption from IFRS 9 or the overlay approach, the Board noted that an insurer could choose to address the additional accounting mismatches and volatility in profit or loss by providing additional disclosures that explain those effects to the users of its financial statements or by using existing accounting options in IFRS 4 (see paragraph BC236).

The costs of analysis for users of financial statements

BC297 The overlay approach and the temporary exemption from IFRS 9 may increase the costs of analysis for users of financial statements, particularly if a user of financial statements invests across insurance and other sectors. This is because the Amendments to IFRS 4 reduce comparability, especially as the temporary exemption and the overlay approach are optional. The Board has sought to mitigate this concern as described in paragraph BC288.

BC298 Furthermore, the Board observed that the overlay approach would provide mitigating benefits for users of financial statements because it allows an insurer to address concerns about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard in a transparent manner, while applying the improved financial reporting requirements in IFRS 9.

BC299 The temporary exemption from IFRS 9 would reduce the accounting mismatches and volatility in profit or loss that may arise from applying IFRS 9 before the forthcoming insurance contracts Standard. However, the Board noted that, if an insurer applies the temporary exemption, it would not provide users of financial statements with the improved information about financial instruments that is required by IFRS 9. The Board has mitigated that loss of information by:

- (a) limiting the temporary exemption to insurers whose activities are predominantly connected with insurance;
- (b) requiring eligibility for the temporary exemption to be assessed at the reporting entity level so that an entity applies either IAS 39 or IFRS 9 to all its financial assets and financial liabilities;
- (c) requiring insurers applying the temporary exemption to provide additional disclosures; and
- (d) setting a fixed expiry date for the temporary exemption.

Dissenting opinions on IFRS 4

- DO1 Professor Barth and Messrs Garnett, G  lard, Leisenring, Smith and Yamada dissent from the issue of IFRS 4.

Dissent of Mary E Barth, Robert P Garnett, Gilbert G  lard, James J Leisenring and John T Smith

- DO2 Messrs Garnett and G  lard dissent for the reasons given in paragraphs DO3 and DO4 and Mr Garnett also dissents for the reasons given in paragraphs DO5 and DO6. Professor Barth and Messrs Leisenring and Smith dissent for the reasons given in paragraphs DO3-DO8 and Mr Smith also dissents for the reasons given in paragraphs DO9-DO13.

Temporary exemption from paragraphs 10-12 of IAS 8

- DO3 Professor Barth and Messrs Garnett, G  lard, Leisenring and Smith dissent because IFRS 4 exempts an entity from applying paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when accounting for insurance and reinsurance contracts. They believe that all entities should be required to apply these paragraphs. These Board members believe that the requirements in IAS 8 have particular relevance and applicability when an IFRS lacks specificities, as does IFRS 4, which allows the continuation of a variety of measurement bases for insurance and reinsurance contracts. Because of the failure to consider the IASB *Framework*,* continuation of such practices may result in the inappropriate recognition of, or inappropriate failure to recognise, assets, liabilities, equity, income and expense. In these Board members' view, if an entity cannot meet the basic requirements of paragraphs 10-12 of IAS 8, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.
- DO4 These Board members' concerns are heightened by the delay in completing phase II of the Board's project on accounting for insurance contracts. Although phase II is on the Board's active agenda, it is unlikely that the Board will be able to develop an IFRS on insurance contracts in the near term. Accordingly, it is likely that the exemption from IAS 8 will be in place for some time.

Future investment margins and shadow accounting

- DO5 Professor Barth and Messrs Garnett, Leisenring and Smith dissent for the further reason that they would not permit entities to change their accounting policies for insurance and reinsurance contracts to policies that include using future investment margins in the measurement of insurance liabilities. They agree with the view expressed in paragraph BC134 that cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect the cash flows arising from the liability or the credit characteristics of the liability). Therefore, they believe that changing to an accounting policy for insurance contracts that uses future investment margins to measure liabilities arising from insurance contracts reduces the relevance and reliability of an insurer's financial statements. They do not believe that other aspects of an accounting model for insurance contracts can outweigh this reduction.

* References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- DO6 These four Board members also would not permit entities to change their accounting policies for insurance and reinsurance contracts to policies that include using what is called shadow accounting. They do not believe that the changes in the carrying amount of insurance liabilities (including related deferred acquisition costs and intangible assets) under shadow accounting should be recognised directly in equity. That these changes in the measurement of the liability are calculated on the basis of changes in the measurement of assets is irrelevant. These Board members believe that these changes in insurance liabilities result in expenses that under the IASB *Framework* should be recognised in profit or loss.

Financial instruments with a discretionary participation Feature*

- DO7 Professor Barth and Messrs Leisenring and Smith would not permit entities to account for a financial instrument with a discretionary participation feature on a basis that differs from that required by IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. Those Standards require entities to separate the components of a compound financial instrument, recognise the liability component initially at fair value, and attribute any residual to the equity component. These three Board members believe that the difficulty in determining whether a discretionary participation feature is a liability or equity does not preclude applying the measurement requirements in IAS 39 to the liability and equity components once the entity makes that determination. These three Board members believe that an entity would misstate interest expense if the financial liability component is not initially measured at its fair value.
- DO8 These three Board members would require entities to ensure in all cases that the liability recognised for financial instruments with a discretionary participation feature is no less than the amount that would result from applying IAS 39 to the guaranteed element. Paragraph 35 of IFRS 4 requires this if an entity classifies none or some of the feature as a liability, but not if it classifies all of the feature as a liability.

Financial instruments*

- DO9 Mr Smith also dissents from IFRS 4 because he believes it defines insurance contracts too broadly and makes unnecessary exceptions to the scope of IAS 32 and IAS 39. In his view, this permits the structuring of contractual provisions to avoid the requirements of those Standards, diminishing their effectiveness and adding considerable complexity in interpreting and applying them and IFRS 4. He believes that many of the exceptions, based on the desire to avoid systems changes, are unnecessary because they generally are unrelated to the second phase of the project on insurance contracts, and they create a disincentive to enhance systems before the second phase of that project is completed. Mr Smith believes that IAS 32 and IAS 39 already contain the appropriate solutions when measurements cannot be made reliably and those solutions make systems limitations transparent.
- DO10 Paragraph 10 of IFRS 4 requires an insurer to unbundle a deposit component of an insurance contract if the insurer can measure the deposit component separately and the insurer's accounting policies do not otherwise require it to recognise all rights and obligations arising from the deposit component. Mr Smith notes that the deposit component consists entirely of financial liabilities or financial assets. Therefore, he believes that the deposit component of all insurance contracts should be unbundled. Mr Smith notes that IAS 32 already requires the liability component of a compound financial instrument to be separated at its fair value with any residual accounted for as

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

equity. He believes this approach could be applied by analogy when an insurance contract contains a financial liability and would represent a superior solution.

- DO11 IFRS 4 amends IAS 39 by stating that an embedded derivative and the host insurance contract are closely related if they are so interdependent that the entity cannot measure the embedded derivative separately. This creates an exemption from the requirement in IAS 39 to account for such embedded derivatives at fair value. Mr Smith disagrees with that change. In particular, if a contract permits a policyholder to obtain a derivative-based cash settlement in lieu of maintaining insurance, Mr Smith believes that the derivative-based cash settlement alternative is a financial liability and should be measured at fair value.
- DO12 For the contracts discussed in the previous paragraph, Mr Smith believes that IAS 39 already provides a superior solution that will not promote structuring to take advantage of an exception to IAS 39. It requires the entire contract to be measured at fair value when an embedded derivative cannot be reliably separated from the host contract. However, Mr Smith would amend IAS 39 to require measurement at cost if a contract cannot be measured reliably at fair value in its entirety and contains a significant insurance component as well as an embedded derivative. This amendment would be consistent with similar requirements in IAS 39 for unquoted equity instruments. To make systems limitations more transparent, Mr Smith would add the disclosure required by IAS 32, including the fact that fair value cannot be measured reliably, a description of the insurance contracts in question, their carrying amounts, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is likely to fall.
- DO13 Mr Smith would exclude from the definition of an insurance contract those contracts that are regarded as transferring significant insurance risk at inception only because they include a pricing option permitting the holder to purchase insurance at a specified price at a later date. He would also exclude from the definition those contracts in which the insurance component has expired. He believes that any remaining obligation is a financial instrument that should be accounted for under IAS 39.

Dissent of Tatsumi Yamada

- DO14 Mr Yamada dissents from the issue of IFRS 4 because he believes that it does not resolve appropriately the mismatch in measurement base between financial assets of insurers and their insurance liabilities. Specifically:
- (a) he disagrees with the inclusion of an option to introduce a current discount rate for designated insurance liabilities.
 - (b) he believes that the Board should have provided a practicable means to reduce the effect of the accounting mismatch using methods based partly on some existing practices that involve broader, but constrained, use of amortised cost.

Option to introduce a current discount rate

- DO15 Mr Yamada disagrees with paragraph 24 of the IFRS, which creates an option to introduce a current market-based discount rate for designated insurance liabilities. He has sympathy for the view expressed in paragraph BC175 that introducing a current market-based discount rate for insurance liabilities rather than a historical discount rate would improve the relevance and reliability of an insurer's financial statements. However, as explained in paragraph BC126, 'the Board will not address discount

rates and the basis for risk adjustments until phase II.” Therefore, Mr Yamada believes that it is not appropriate to deal with measurement of insurance liabilities in phase I of this project.

- DO16 In addition, Mr Yamada believes that there should be a stringent test to assess whether changes in the carrying amount of the designated insurance liabilities mitigate the changes in carrying amount of financial assets. Without such a test, management will have a free choice to decide the extent to which it introduces remeasurement of insurance liabilities. Therefore, he does not agree with the Board’s conclusion in paragraph BC176 that ‘the increase in relevance and reliability from introducing a current discount rate could outweigh the disadvantages of permitting accounting policies that are not applied consistently to all similar liabilities’.
- DO17 Furthermore, the option introduced by paragraph 24 is not an effective way to reduce the accounting mismatch, in Mr Yamada’s view. He agrees with the Board’s analysis that “many insurers may not have systems to adjust liabilities for changes in interest rates and may not wish to develop such systems, even for designated liabilities as opposed to all liabilities”, as explained in paragraph BC177(d)(i).

Assets held to back insurance liabilities*

- DO18 As stated in paragraph BC171, many of the respondents to ED 5 urged the Board to explore ways of reducing the accounting mismatch. Mr Yamada notes that IFRS 4 provides some limited solutions for the accounting mismatch by clarifying that shadow accounting can be used and amending IAS 40 to permit two separate elections when an entity selects the fair value model or the cost model for investment property. IFRS 4 also provides an option to introduce a current market-based discount rate for designated insurance liabilities but, for reasons given in paragraphs DO15-DO17, Mr Yamada does not support that option.
- DO19 Mr Yamada believes that it would have been appropriate to provide a more broadly applicable way of mitigating the effect of the accounting mismatch. Because phase I is only a stepping stone to phase II, Mr Yamada is of the view that the only practicable solution in the short term is one based on the existing practices of insurers. He believes that if remeasurement of insurance liabilities by a current market-based discount rate is allowed as means of resolving the mismatch, a new category of assets carried at amortised cost such as the Japanese ‘debt securities earmarked for policy reserve’ (DSR) should also have been allowed in phase I.
- DO20 Although Mr Yamada acknowledges that the DSR approach would not lead to more relevant and reliable measurements, he notes that insurers have several years’ experience of using this approach, which was created in 2000 when Japan introduced an accounting standard for financial instruments that is similar to IASs 32 and 39. He believes that no perfect solution is available in phase I and together with the disclosure of fair value information required by IAS 32, the DSR approach would provide a reasonable solution for phase I. Therefore he does not agree with the Board’s conclusion in paragraph BC178 that amending the existing measurement requirements in IAS 39 for financial assets “would have reduced the relevance and reliability of financial statements to an unacceptable extent”. Indeed, Mr Yamada believes the exemption in IFRS 4 from paragraphs 10-12 of IAS 8 could impair the relevance and reliability of financial statements more than introducing the DSR approach would have done.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Dissenting opinion on the Amendments to IFRS 4

Dissent of Mary Tokar from *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)* as issued in September 2016

- DO1 Ms Tokar dissents from the issue of the Amendments to IFRS 4 because she disagrees with providing a temporary exemption from IFRS 9 for insurers whose activities are predominantly connected with insurance. She believes that it is important for IFRS 9 to be applied without delay because of the significant improvements that IFRS 9 requires in accounting for financial assets, including a new impairment model that is based on expected credit losses and the related enhanced disclosures about credit risk. She notes that these improvements were made in response to calls from regulators and users of financial statements after the global financial crisis and many of those parties have called for these improvements to be introduced without delay. She also notes that the temporary exemption from IFRS 9 will reduce comparability among reporting entities, including among insurers.
- DO2 Ms Tokar agrees that there are valid concerns about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. She agrees that the classification and measurement requirements in IFRS 9 may lead to new accounting mismatches and, hence, an increase in reported volatility within profit or loss for those insurers that measure insurance contracts on a cost basis under IFRS 4. She also notes that some of that volatility is expected to be offset in profit or loss when the forthcoming insurance contracts Standard is applied because that forthcoming Standard is expected to require insurers to measure insurance contracts using current estimates of future cash flows discounted at a current rate.
- DO3 Ms Tokar believes that the amendment to permit insurers to use the overlay approach makes a temporary exemption from IFRS 9 unnecessary. She notes that the overlay approach deals more appropriately with the concerns expressed about additional accounting mismatches and volatility because the overlay approach:
- (a) provides users of financial statements with the benefits of the improved accounting required by IFRS 9 but also removes the effect of potential additional volatility from profit or loss for designated financial assets until the forthcoming insurance contracts Standard is applied.
 - (b) makes it easier for users of financial statements to compare the financial statements of insurers that apply the overlay approach with those that do not, as well as with other entities that hold similar financial assets. This comparability will be reduced if some insurers apply a temporary exemption from IFRS 9.
- DO4 Ms Tokar observed that the Board and staff undertook extensive outreach with users of financial statements while developing, and following the publication of, the Exposure Draft in December 2015. This outreach was global and involved both users specialising in insurance activities and non-specialist users. Many users expressed the view that entities should apply IFRS 9 in 2018 (ie when that Standard is mandatory), even if this is before the application of the forthcoming insurance contracts Standard, because IFRS 9 provides improved information about financial instruments. Those users of financial statements expressed the view that if the Board decided to address preparers' concerns regarding increases in accounting mismatches

and volatility then only the overlay approach should be used. They expressed this preference because the overlay approach maintains the comparability of financial statements by requiring all entities to apply IFRS 9 while addressing volatility in a transparent way.

- DO5 Ms Tokar also notes that, as a result of the Amendments to IFRS 4, three different reporting outcomes will exist for insurers: (a) application of IFRS 9 without the overlay approach; (b) application of IFRS 9 with the overlay approach; and (c) use of the temporary exemption from IFRS 9. She believes that this variety in approaches to accounting for financial instruments may significantly reduce comparability among insurers, and between insurers and other entities. She observes that reduced comparability is one of the concerns expressed by users of financial statements about the temporary exemption.

Revised Guidance on Implementing HKFRS 4

Insurance Contracts



Hong Kong Institute of
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Guidance on implementing IFRS 4 *Insurance Contracts*

This guidance accompanies, but is not part of, IFRS 4.

Introduction

IG1 This implementation guidance:

- (a) illustrates which contracts and embedded derivatives are within the scope of the IFRS (see paragraphs IG2–IG4).
- (b) includes an example of an insurance contract containing a deposit component that needs to be unbundled (paragraph IG5).
- (c) illustrates shadow accounting (paragraphs IG6–IG10).
- (d) discusses how an insurer might satisfy the disclosure requirements in the IFRS (paragraphs IG11–IG71).

Definition of insurance contract

IG2 IG Example 1 illustrates the application of the definition of an insurance contract. The example does not illustrate all possible circumstances.

IG Example 1: Application of the definition of an insurance contract		
Contract type		Treatment in phase I
1.1	Insurance contract (see definition in Appendix A of the IFRS and guidance in Appendix B).	Within the scope of the IFRS, unless covered by scope exclusions in paragraph 4 of the IFRS. Some embedded derivatives and deposit components must be separated (see IG Examples 2 and 3 and paragraphs 7-12 of the IFRS).
1.2	Death benefit that could exceed amounts payable on surrender or maturity.	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the policyholder dies early. See IG Examples 1.23-27 for further discussion of surrender penalties. <u>continued...</u>

<u>...continued</u>		
<u>IG Example 1: Application of the definition of an insurance contract</u>		
1.3	A unit-linked contract that pays benefits linked to the fair value of a pool of assets. The benefit is 100 per cent of the unit value on surrender or maturity and 101 per cent of the unit value on death.	This contract contains a deposit component (100 per cent of unit value) and an insurance component (additional death benefit of 1 per cent). Paragraph 10 of the IFRS permits unbundling (but requires it only if the insurance component is material and the issuer would not otherwise recognise all obligations and rights arising under the deposit component). If the insurance component is not unbundled, the whole contract is an investment contract because the insurance component is insignificant in relation to the whole contract.
1.4	Life-contingent annuity.	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.
1.5	Pure endowment. The insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then.	Insurance contract (unless the transfer of insurance risk is insignificant). If a relatively homogeneous book of pure endowments is known to consist of contracts that all transfer insurance risk, the insurer may classify the entire book as insurance contracts without examining each contract to identify a few non-derivative pure endowments that transfer insignificant insurance risk (see paragraph B25).
1.6	Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates guaranteed at inception.	Insurance contract (unless the transfer of insurance risk is insignificant). The contract transfers mortality risk to the insurer at inception, because the insurer might have to pay significant additional benefits for an individual contract if the annuitant elects to take the life-contingent annuity and survives longer than expected (unless the contingent amount is insignificant in all scenarios that have commercial substance).
1.7	Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates prevailing when the annuity begins.	Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Within the scope of ~~IAS 39~~ IFRS 9 Financial Instruments: Recognition and Measurement unless the contract contains a discretionary participation feature. Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all scenarios that have commercial substance). <u>continued...</u>

<u>...continued</u>		
IG Example 1: Application of the definition of an insurance contract		
1.8	Investment contract ^(a) that does not contain a discretionary participation feature.	Within the scope of ~~IFRS 9~~ IAS 39.
1.9	Investment contract containing a discretionary participation feature.	Paragraph 35 of the IFRS sets out requirements for these contracts, which are excluded from the scope of ~~IFRS 9~~ IAS 39.
1.10	Investment contract in which payments are contractually linked (with no discretion) to returns on a specified pool of assets held by the issuer.	Within the scope of ~~IFRS 9~~ IAS 39. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph ~~B4.3.8(g)~~ of IFRS 9 ~~AC33(g)~~ of Appendix A of IAS 39).
1.11	Contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. The contract may have various legal forms (eg insurance contract, guarantee or letter of credit).	Insurance contract, but within the scope of ~~IFRS 9~~IAS 39, not IFRS 4. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either ~~IFRS 9~~IAS 39 and IAS 32^(b) or IFRS 4 to such financial guarantee contracts. The legal form of the contract does not affect its recognition and measurement. Accounting by the holder of such a contract is excluded from the scope of ~~IFRS 9~~IAS 39 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10-12 of IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> apply. Those paragraphs specify criteria to use in developing an accounting policy if no IFRS applies specifically to an item.
1.12	A credit-related guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index.	Not an insurance contract. A derivative within the scope of ~~IFRS 9~~IAS 39.
1.13	Guarantee fund established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, eg insurance, banking or travel.	The contract that establishes the guarantee fund is an insurance contract (see IG Example 1.11).
<u>continued...</u>		

<u>...continued</u>		
IG Example 1: Application of the definition of an insurance contract		
1.14	Guarantee fund established by law.	The commitment of participants to contribute to the fund is not established by a contract, so there is no insurance contract. Within the scope of IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> .
1.15	Residual value insurance or residual value guarantee. Guarantee by one party of the fair value at a future date of a non-financial asset held by a beneficiary of the insurance or guarantee.	Insurance contract within the scope of the IFRS (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable). However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and within the scope of <u>IFRS 9</u>~~IAS 39~~. Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 <i>Leases</i>.
1.16	Product warranties issued directly by a manufacturer, dealer or retailer.	Insurance contracts, but excluded from the scope of the IFRS (see <u>IFRS 15 Revenue from Contracts with Customers</u> ~~IAS 18 Revenue~~ and IAS 37).
1.17	Product warranties issued by a third party.	Insurance contracts, no scope exclusion. Same treatment as other insurance contracts.
1.18	Group insurance contract that gives the insurer an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money.	Insurance risk is insignificant. Therefore, the contract is a financial ~~asset~~ instrument within the scope of <u>IFRS 9</u> ~~IAS 39~~ . Servicing fees are within the scope of <u>IFRS 15</u> ~~IAS 18~~ (recognise when (or as) services are provided, subject to various conditions).
1.19	Catastrophe bond: bond in which principal, interest payments or both are reduced if a specified triggering event occurs and the triggering event does not include a condition that the issuer of the bond suffered a loss.	Financial instrument with embedded derivative within the scope of IFRS 9. ~~Both the holder and the issuer measure the embedded derivative at fair value.~~
1.20	Catastrophe bond: bond in which principal, interest payments or both are reduced significantly if a specified triggering event occurs and the triggering event includes a condition that the issuer of the bond suffered a loss.	The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component. (a) If specified conditions are met, paragraph 10 of the IFRS requires the holder to unbundle the deposit component and apply <u>IFRS 9</u>~~IAS 39~~ to it. <u>continued...</u>

<u>...continued</u>		
IG Example 1: Application of the definition of an insurance contract		
		(b) The issuer accounts for the insurance component as reinsurance if it uses the bond for that purpose. If the issuer does not use the insurance component as reinsurance, it is not within the scope of the IFRS, which does not address accounting by policyholders for direct insurance contracts. (c) Under paragraph 13 of the IFRS, the holder could continue its existing accounting for the insurance component, unless that involves the practices prohibited by paragraph 14.
1.21	An insurance contract issued by an insurer to a defined benefit pension plan covering the employees of the insurer, or of another entity consolidated within the same financial statements as the insurer.	The contract will generally be eliminated from the financial statements, which will include: (a) the full amount of the pension obligation under IAS 19 <i>Employee Benefits</i>, with no deduction for the plan's rights under the contract. (b) no liability to policyholders under the contract. (c) the assets backing the contract.
1.22	An insurance contract issued to employees as a result of a defined contribution pension plan. The contractual benefits for employee service in the current and prior periods are not contingent on future service. The insurer also issues similar contracts on the same terms to third parties.	Insurance contract within the scope of the IFRS. If the employer pays part or all of the employee's premiums, the payment by the employer is an employee benefit within the scope of IAS 19. See also IAS 19, paragraphs 39-42 and 104-104D. Furthermore, a 'qualifying insurance policy' as defined in IAS 19 need not meet the definition of an insurance contract in this IFRS.
1.23	Loan contract containing a prepayment fee that is waived if prepayment results from the borrower's death.	Not an insurance contract. Before entering into the contract, the borrower faced no risk corresponding to the prepayment fee. Hence, although the loan contract exposes the lender to mortality risk, it does not transfer a pre-existing risk from the borrower. Thus, the risk associated with the possible waiver on death of the prepayment fee is not insurance risk (paragraphs B12 and B24(b) of Appendix B of the IFRS).
<u>continued...</u>		

<u>...continued</u>		
<u>IG Example 1: Application of the definition of an insurance contract</u>		
1.24	Loan contract that waives repayment of the entire loan balance if the borrower dies.	This contract contains a deposit component (the loan) and an insurance component (waiver of the loan balance on death, equivalent to a cash death benefit). If specified conditions are met, paragraph 10 of the IFRS requires or permits unbundling. If the insurance component is not unbundled, the contract is an insurance contract if the insurance component is significant in relation to the whole contract.
1.25	A contract permits the issuer to deduct a market value adjustment (MVA) from surrender values or death benefits to reflect current market prices for the underlying assets. The contract does not permit an MVA for maturity benefits.	The policyholder obtains an additional survival benefit because no MVA is applied at maturity. That benefit is a pure endowment (see IG Example 1.5). If the risk transferred by that benefit is significant, the contract is an insurance contract.
1.26	A contract permits the issuer to deduct an MVA from surrender values or maturity payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death benefits.	The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that benefit is significant, the contract is an insurance contract.
1.27	A contract permits the issuer to deduct an MVA from surrender payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.	The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money (see paragraph B27 of the IFRS). The contract is an investment contract. This contract combines the two features discussed in IG Examples 1.25 and 1.26. When considered separately, those two features transfer insurance risk. However, when combined, they do not transfer insurance risk. Therefore, it is not appropriate to separate this contract into two 'insurance' components. If the amount payable on death were not adjusted in full for the time value of money, or were adjusted in some other way, the contract might transfer insurance risk. If that insurance risk is significant, the contract is an insurance contract.
<u>continued...</u>		

...continued		
IG Example 1: Application of the definition of an insurance contract		
1.28	A contract meets the definition of an insurance contract. It was issued by one entity in a group (for example a captive insurer) to another entity in the same group.	If the entities present individual or separate financial statements, they treat the contract as an insurance contract in those individual or separate financial statements (see IAS 27 <i>Separate Financial Statements</i>). The transaction is eliminated from the group's consolidated financial statements. If the intragroup contract is reinsured with a third party that is not part of the group, the reinsurance contract is treated as a direct insurance contract in the consolidated financial statements because the intragroup contract is eliminated on consolidation.
1.29	An agreement that entity A will compensate entity B for losses on one or more contracts issued by entity B that do not transfer significant insurance risk.	The contract is an insurance contract if it transfers significant insurance risk from entity B to entity A, even if some or all of the individual contracts do not transfer significant insurance risk to entity B. The contract is a reinsurance contract if any of the contracts issued by entity B are insurance contracts. Otherwise, the contract is a direct insurance contract.
(a) The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract.		
(b) When an entity applies IFRS 7 <i>Financial Instruments: Disclosures</i> , the reference to IAS 32 is replaced by a reference to IFRS 7.		

Embedded derivatives

- IG3 ~~IAS 39~~ IFRS 9 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the IFRS). Nevertheless, separation and fair value measurement of such an embedded derivative are not prohibited if the insurer's existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the IFRS.
- IG4 IG Example 2 illustrates the treatment of embedded derivatives contained in insurance contracts and investment contracts. The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract. The example does not illustrate all possible circumstances. Throughout the example, the phrase 'fair value measurement is required' indicates that the issuer of the contract is required:
- (a) to measure the embedded derivative at fair value and include changes in its fair value in profit or loss.
 - (b) to separate the embedded derivative from the host contract, unless it measures the entire contract at fair value and includes changes in that fair value in profit or loss.

IG Example 2: Embedded derivatives			
Type of embedded derivative		Treatment if embedded in a host insurance contract	Treatment if embedded in a host investment contract
2.1	Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.	The equity-index feature is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.2	Death benefit that is the greater of: (a) unit value of an investment fund (equal to the amount payable on surrender or maturity); and (b) guaranteed minimum.	Excess of guaranteed minimum over unit value is a death benefit (similar to the payout on a dual trigger contract, see IG Example 2.19). This meets the definition of an insurance contract (unless the life-contingent payments are insignificant) and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.3	Option to take a life-contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).	The embedded option is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.4	Embedded guarantee of minimum interest rates in determining surrender or maturity values that is at or out of the money on issue, and not leveraged.	The embedded guarantee is not an insurance contract (unless significant payments are life-contingent^(a)). However, it is closely related to the host contract (paragraph B4.3.8(b) of IFRS 9AG33(b) of Appendix A of IAS 39). Fair value measurement is not required (but not prohibited). If significant payments are life-contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the deposit component (paragraph 10 of	Fair value measurement is not permitted (paragraph B4.3.8(b) of IFRS 9AG33(b) of IAS 39). <i>continued...</i>

...continued**IG Example 2: Embedded derivatives**

		the IFRS).	
		If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be interdependent; if the option to cancel the deposit component cannot be measured separately (ie without considering the other option), both options are regarded as part of the insurance component (paragraph B4.3.8(h) of IFRS 9 ~~AG33(h) of IAS 39~~).	
2.5	Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue, or leveraged.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent). Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9 ~~AG33(b) of IAS 39~~).	Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9 ~~AG33(b) of IAS 39~~).
2.6	Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices:		
	(a) guarantee relates only to payments that are life-contingent.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
	(b) guarantee relates only to payments that are not life-contingent.	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9 ~~AG33(b) of IAS 39~~).	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9 ~~AG33(b) of IAS 39~~).

continued...

<u>...continued</u>			
<u>IG Example 2: Embedded derivatives</u>			
	(c) policyholder can elect to receive life-contingent payments or payments that are not life-contingent, and the guarantee relates to both. When the policyholder makes its election, the issuer cannot adjust the pricing of the life-contingent payments to reflect the risk that the insurer assumes at that time (see paragraph B29 of the IFRS for discussion of contracts with separate accumulation and payout phases)	The embedded option to benefit from a guarantee of life-contingent payments is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited). The embedded option to receive payments that are not life-contingent ('the second option') is not an insurance contract. However, because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the insurance contract. In that case, fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.7	Embedded guarantee of minimum equity returns on surrender or maturity.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.8	Equity-linked return available on surrender or maturity.	The embedded derivative is not an insurance contract (unless the equity-linked return is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
<u>continued...</u>			

...continued**IG Example 2: Embedded derivatives**

		because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the host insurance contract. In that case, fair value measurement is not required (but not prohibited).	
2.12	Policyholder option to surrender a contract for a cash surrender value specified in a schedule (ie not indexed and not accumulating interest).	Fair value measurement is not required (but not prohibited: paragraph 8 of the IFRS). The surrender value may be viewed as a deposit component, but the IFRS does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph ~~B4.3.5(e) of IFRS 9~~ ~~AG30(g) of IAS 39~~). Otherwise, the surrender option is measured at fair value.
2.13	Policyholder option to surrender a contract for account value based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest-bearing securities), possibly after deducting a surrender charge.	Same as for a cash surrender value (IG Example 2.12).	Same as for a cash surrender value (IG Example 2.12).
2.14	Policyholder option to surrender a contract for a surrender value based on an equity or commodity price or index.	The option is not closely related to the host contract (unless the option is life-contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the IFRS and ~~B4.3.5(c) and (d) of IFRS 9~~ ~~AG30(d) and (e) of IAS 39~~).	Fair value measurement is required (paragraph ~~B4.3.5(c) and (d) of IFRS 9~~ ~~AG30(d) and (e) of IAS 39~~).

continued...

<u>...continued</u>			
<u>IG Example 2: Embedded derivatives</u>			
2.15	Policyholder option to surrender a contract for account value equal to the fair value of a pool of equity investments, possibly after deducting a surrender charge.	If the insurer measures that portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender value differs significantly from account value) (see paragraph <u>B4.3.8(g) of IFRS 9</u> ~~AG33(g) of IAS 39~~). Otherwise, fair value measurement is required.	If the insurer regards the account value as the amortised cost or fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from account value). Otherwise, fair value measurement is required.
2.16	Contractual feature that provides a return contractually linked (with no discretion) to the return on specified assets.	The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph <u>B4.3.5(f) of IFRS 9</u> ~~AG30(h) of IAS 39~~). Fair value measurement is required.	Fair value measurement is required.
2.17	Persistency bonus paid at maturity in cash (or as a period-certain annuity).	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the IFRS). Fair value measurement is required.	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph <u>B4.3.5(b) of IFRS 9</u> ~~AG30(c) of IAS 39~~). If the option or provision is not closely related to the host instrument, fair value measurement is required.
2.18	Persistency bonus paid at maturity as an enhanced life-contingent annuity.	The embedded derivative is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant). <u>continued...</u>

<u>...continued</u>			
<u>IG Example 2: Embedded derivatives</u>			
2.19	Dual trigger contract, eg contract requiring a payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events occur.	The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance). A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire (paragraph B30 of the IFRS). Therefore, although the remaining exposure is similar to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the first trigger lacks commercial substance).
2.20	Non-guaranteed participating dividend contained in a life insurance contract. The amount is contractually at the discretion of the insurer but is contractually based on the insurer's actual experience on the related block of insurance contracts.	The contract contains a discretionary participation feature, rather than an embedded derivative (paragraph 34 of the IFRS).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
(a) Payments are life-contingent if they are contingent on death or contingent on survival.			

Unbundling a deposit component

IG5 Paragraph 10 of the IFRS requires an insurer to unbundle some insurance contracts that contain a deposit component. IG Example 3 illustrates this requirement. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, unbundling is not required if the insurer recognises all obligations or rights arising from the deposit component.

IG Example 3: Unbundling a deposit component of a reinsurance contract

Background

A reinsurance contract has the following features:

- (a) The cedant pays premiums of CU10^(a) every year for five years.
- (b) An experience account is established, equal to 90 per cent of cumulative premiums (including the additional premiums discussed in (c) below) less 90 per cent of cumulative claims.
- (c) If the balance in the experience account is negative (ie cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.
- (d) At the end of the contract, if the experience account balance is positive (ie cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.
- (e) Neither party can cancel the contract before maturity.
- (f) The maximum loss that the reinsurer is required to pay in any period is CU200.

This contract is an insurance contract because it transfers significant insurance risk to the reinsurer. For example, in case 2 discussed below, the reinsurer is required to pay additional benefits with a present value, in year 1, of CU35, which is clearly significant in relation to the contract.

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IG Example 3: Unbundling a deposit component of a reinsurance contract

The following discussion addresses the accounting by the reinsurer. Similar principles apply to the accounting by the cedant.

Application of requirements: case 1—no claims

If there are no claims, the cedant will receive CU45 in year 5 (90 per cent of the cumulative premiums of CU50). In substance, the cedant has made a loan, which the reinsurer will repay in one instalment of CU45 in year 5.

If the reinsurer's accounting policies require it to recognise its contractual liability to repay the loan to the cedant, unbundling is permitted but not required. However, if the reinsurer's accounting policies would not require it to recognise the liability to repay the loan, the reinsurer is required to unbundle the contract (paragraph 10 of the IFRS).

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows. Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying ~~IAS 39~~ IFRS 9 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be measured by discounting the future cash flows from the deposit component using a valuation technique. Assume that an appropriate discount rate is 10 per cent and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of CU10 by the cedant is then made up of a loan advance of CU6.7 and an insurance premium of CU3.3.

The reinsurer accounts for the insurance component in the same way that it accounts for a separate insurance contract with an annual premium of CU3.3.

The movements in the loan are shown below.

Year	Opening Balance	Interest at 10 per cent	Advance (repayment)	Closing balance
	CU	CU	CU	CU
0	0.00	0.00	6.70	6.70
1	6.70	0.67	6.70	14.07
2	14.07	1.41	6.70	22.18
3	22.18	2.21	6.70	31.09
4	31.09	3.11	6.70	40.90
5	40.90	<u>4.10</u>	<u>(45.00)</u>	0.00
Total		<u>11.50</u>	<u>(11.50)</u>	

continued...

*...continued***IG Example 3: Unbundling a deposit component of a reinsurance contract***Application of requirements: case 2—claim of CU150 in year 1*

Consider now what happens if the reinsurer pays a claim of CU150 in year 1. The changes in the experience account, and resulting additional premiums, are as follows.

Year	Premium	Additional premium	Total premium	Cumulative premium	Claims	Cumulative claims	Cumulative premiums less claims	Experience account
	CU	CU	CU	CU	CU	CU	CU	CU
0	10	0	10	10	0	0	10	9
1	10	0	10	20	(150)	(150)	(130)	(117)
2	10	39	49	69	0	(150)	(81)	(73)
3	10	36	46	115	0	(150)	(35)	(31)
4	10	<u>31</u>	<u>41</u>	156	<u>0</u>	(150)	6	6
		<u>106</u>	<u>156</u>		<u>(150)</u>			

Incremental cash flows because of the claim in year 1

The claim in year 1 leads to the following incremental cash flows, compared with case 1:

Year	Additional premium	Claims	Refund in case 2	Refund in case 1	Net incremental cash flow	Present value at 10 per cent
	CU	CU	CU	CU	CU	CU
0	0	0			0	0
1	0	(150)			(150)	(150)
2	39	0			39	35
3	36	0			36	30
4	31	0			31	23
5	<u>0</u>	<u>0</u>	<u>(6)</u>	<u>(45)</u>	<u>39</u>	<u>27</u>
Total	<u>106</u>	<u>(150)</u>	<u>(6)</u>	<u>(45)</u>	<u>(5)</u>	<u>(35)</u>

The incremental cash flows have a present value, in year 1, of CU35 (assuming a discount rate of 10 per cent is appropriate). Applying paragraphs 10-12 of the IFRS, the cedant unbundles the contract and applies ~~IFRS 9~~ **IAS 39** to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the CU150 received in year 1 as income, and the incremental payments in years 2-5 as expenses. However, in substance, the reinsurer has paid a claim of CU35 and made a loan of CU115 (CU150 less CU35) that will be repaid in instalments.

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IG Example 3: Unbundling a deposit component of a reinsurance contract

The following table shows the changes in the loan balance. The table assumes that the original loan shown in case 1 and the new loan in case 2 met the criteria for offsetting in IAS 32. Amounts shown in the table are rounded.

Loan to (from) the reinsurer

Year	Opening balance	Interest at 10 per cent	Payments per original schedule	Additional payments in case 2	Closing balance
	CU	CU	CU	CU	CU
0	-	-	6	-	6
1	6	1	7	(115)	(101)
2	(101)	(10)	7	39	(65)
3	(65)	(7)	7	36	(29)
4	(29)	(3)	6	31	5
5	5	<u>1</u>	<u>(45)</u>	<u>39</u>	0
Total		<u>(18)</u>	<u>(12)</u>	<u>30</u>	

(a) In this Implementation Guidance monetary amounts are denominated in 'currency units (CU)'.

Shadow accounting

- IG6 Paragraph 30 of the IFRS permits, but does not require, a practice sometimes described as "shadow accounting". IG Example 4 illustrates shadow accounting.
- IG7 Shadow accounting is not the same as fair value hedge accounting under IFRS 9. ~~IAS 39 and will not usually have the same effect. Under IAS 39, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of foreign currency risk.~~
- IG8 Shadow accounting is not applicable for liabilities arising from investment contracts (ie contracts within the scope of IAS 39) because the underlying measurement of those liabilities (including the treatment of related transaction costs) does not depend on asset values or asset returns. However, shadow accounting may be applicable for a discretionary participation feature within an investment contract if the measurement of that feature depends on asset values or asset returns.
- IG9 Shadow accounting is not applicable if the measurement of an insurance liability is not driven directly by realised gains and losses on assets held. For example, assume that financial assets are measured at fair value and insurance liabilities are measured using a discount rate that reflects current market rates but does not depend directly on the actual assets held. The measurements of the assets and the liability both reflect changes in interest rates, but the measurement of the liability does not depend directly on the carrying amount of the assets held. Therefore, shadow accounting is not applicable and changes in the carrying amount of the liability are recognised in profit or loss because IAS 1 *Presentation of Financial Statements* requires all items of income or expense to be recognised in profit or loss unless a IFRS requires otherwise.

- IG10 Shadow accounting may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an entity uses the revaluation model in IAS 16 *Property, Plant and Equipment*, it recognises changes in the carrying amount of the owner-occupied property in revaluation surplus. If it also elects to use shadow accounting, the changes in the measurement of the insurance liability resulting from revaluations of the property are also recognised in revaluation surplus.

IG Example 4: Shadow accounting

Background

Under some accounting requirements for some insurance contracts, deferred acquisition costs (DAC) are amortised over the life of the contract as a constant proportion of estimated gross profits (EGP). EGP includes investment returns, including realised (but not unrealised) gains and losses. Interest is applied to both DAC and EGP, to preserve present value relationships. For simplicity, this example ignores interest and ignores re-estimation of EGP.

At the inception of a contract, insurer A has DAC of CU20 relating to that contract and the present value, at inception, of EGP is CU100. In other words, DAC is 20 per cent of EGP at inception. Thus, for each CU1 of realised gross profits, insurer A amortises DAC by CU0.20. For example, if insurer A sells assets and recognises a gain of CU10, insurer A amortises DAC by CU2 (20 per cent of CU10).

Before adopting IFRSs for the first time in 20X5, insurer A measured financial assets on a cost basis. (Therefore, EGP under those national accounting requirements considers only realised gains and losses.) However, under IFRSs, it classifies its financial assets as measured at fair value through profit or loss, available for sale. Thus, ~~insurer A measures the assets at fair value and recognises changes in their fair value in other comprehensive income.~~

In 20X5, insurer A recognises unrealised gains of CU10 on the assets backing the contract ~~and~~. In 20X6, ~~insurer A sells the assets for an amount equal to their fair value at the end of 20X5 and, to comply with IAS 39, reclassifies the now realised gain of CU10 from equity to profit or loss as a reclassification adjustment.~~

Application of paragraph 30 of the IFRS

Paragraph 30 of the IFRS permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 20X5 by an additional CU2 (20 per cent of CU10) as a result of the change in the fair value of the assets. ~~Because insurer A recognised the change in their fair value in other comprehensive income, it~~ Insurer A recognises the additional amortisation of CU2 in profit or loss ~~other comprehensive income~~.

When insurer A sells the assets in 20X6, it makes no further adjustment to DAC, ~~but reclassifies DAC amortisation of CU2, relating to the now realised gain, from equity to profit or loss as a reclassification adjustment.~~

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain, ~~except that the unrealised gain and resulting DAC amortisation are (a) recognised in other comprehensive income rather than in profit or loss and (b) reclassified from equity to profit or loss when the gain on the asset becomes realised.~~ If insurer A does not adopt shadow accounting, unrealised gains on assets do not affect the amortisation of DAC.

Disclosure

Purpose of this guidance

IG11 The guidance in paragraphs IG12-IG71 suggests possible ways to apply the disclosure requirements in paragraphs 36-39A of the IFRS. As explained in paragraphs 36 and 38 of the IFRS, the objective of the disclosures is:

- (a) to identify and explain the amounts in an insurer's financial statements arising from insurance contracts; and
- (b) to enable users of those financial statements to evaluate the nature and extent of risks arising from insurance contracts.

IG12 An insurer decides in the light of its circumstances how much detail it gives to satisfy those requirements, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information that has materially different characteristics. It is necessary to strike a balance so that important information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have materially different characteristics. For example:

- (a) a large international insurance group that operates in a wide range of regulatory jurisdictions typically provides disclosures that differ in format, content and detail from those provided by a specialised niche insurer operating in one jurisdiction.
- (b) many insurance contracts have similar characteristics. When no single contract is individually material, a summary by classes of contracts is appropriate.
- (c) information about an individual contract may be material when it is, for example, a significant contributor to an insurer's risk profile.

To satisfy the requirements, an insurer would not typically need to disclose all the information suggested in the guidance. This guidance does not create additional requirements.

IG13 IAS 1 *Presentation of Financial Statements* requires an entity to 'provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

IG14 For convenience, this Implementation Guidance discusses each disclosure requirement in the IFRS separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures may satisfy more than one requirement. For example, information about the assumptions that have the greatest effect on the measurement of amounts arising from insurance contracts may help to convey information about insurance risk and market risk.

Materiality

IG15 IAS 1 notes that a specific disclosure requirement in an IFRS need not be satisfied if the information is not material. IAS 1 defines materiality as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

IG16 IAS 1 also explains the following:

Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25* that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Explanation of recognised amounts (paragraphs 36 and 37 of the IFRS)

Accounting policies

IG17 IAS 1 requires disclosure of accounting policies and paragraph 37(a) of the IFRS highlights this requirement. In developing disclosures about accounting policies for insurance contracts, an insurer might conclude that it needs to address the treatment of, for example, some or all of the following, if applicable:

- (a) premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums).
- (b) fees or other charges made to policyholders.
- (c) acquisition costs (including a description of their nature).
- (d) claims incurred (both reported and not reported), claims handling costs (including a description of their nature) and liability adequacy tests (including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in those tests, see paragraphs 15-19 of the IFRS). An insurer might disclose whether insurance liabilities are discounted and, if they are discounted, explain the methodology used.
- (e) the objective of methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models, and the source of information used in the models.
- (f) embedded options and guarantees (including a description of whether (i) the measurement of insurance liabilities reflects the intrinsic value and time value of these items and (ii) their measurement is consistent with observed current market prices).
- (g) discretionary participation features (including a clear statement of how the insurer applies paragraphs 34 and 35 of the IFRS in classifying that feature as a liability or as a component of equity) and other features that permit policyholders to share in investment performance.

* ~~IASC's Framework for the Preparation and Presentation of Financial Statements~~ was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraph 25 was superseded by Chapter 3 of the *Conceptual Framework*.

- (h) salvage, subrogation or other recoveries from third parties.
- (i) reinsurance held.
- (j) underwriting pools, coinsurance and guarantee fund arrangements.
- (k) insurance contracts acquired in business combinations and portfolio transfers, and the treatment of related intangible assets.
- (l) as required by IAS 1, the judgements, apart from those involving estimations, management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. The classification of discretionary participation features is an example of an accounting policy that might have a significant effect.

IG18 If the financial statements disclose supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, it is appropriate to explain the basis. Disclosures about embedded value methodology might include information similar to that described in paragraph IG17, as well as disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.

Assets, liabilities, income and expense

IG19 Paragraph 37(b) of the IFRS requires an insurer to disclose the assets, liabilities, income and expenses that arise from insurance contracts. If an insurer presents its statement of cash flows using the direct method, paragraph 37(b) requires it also to disclose the cash flows that arise from insurance contracts. The IFRS does not require disclosure of specific cash flows. The following paragraphs discuss how an insurer might satisfy those general requirements.

IG20 IAS 1 requires minimum disclosures in the statement of financial position. An insurer might conclude that, to satisfy those requirements, it needs to present separately in its statement of financial position the following amounts arising from insurance contracts:

- (a) liabilities under insurance contracts and reinsurance contracts issued.
- (b) assets under insurance contracts and reinsurance contracts issued.
- (c) assets under reinsurance ceded. Under paragraph 14(d)(i) of the IFRS, these assets are not offset against the related insurance liabilities.

IG21 Neither IAS 1 nor the IFRS prescribes the descriptions and ordering of the line items presented in the statement of financial position. An insurer could amend the descriptions and ordering to suit the nature of its transactions.

IG22 IAS 1 requires disclosure, either in the statement of financial position or in the notes, of subclassifications of the line items presented, classified in a manner appropriate to the entity's operations. Appropriate subclassifications of insurance liabilities will depend on the circumstances, but might include items such as:

- (a) unearned premiums.
- (b) claims reported by policyholders.
- (c) claims incurred but not reported (IBNR).
- (d) provisions arising from liability adequacy tests.

- (e) provisions for future non-participating benefits.
- (f) liabilities or components of equity relating to discretionary participation features (see paragraphs 34 and 35 of the IFRS). If an insurer classifies these features as a component of equity, disclosure is needed to comply with IAS 1, which requires an entity to disclose 'a description of the nature and purpose of each reserve within equity.'
- (g) receivables and payables related to insurance contracts (amounts currently due to and from agents, brokers and policyholders related to insurance contracts).
- (h) non-insurance assets acquired by exercising rights to recoveries.

IG23 Similar subclassifications may also be appropriate for reinsurance assets, depending on their materiality and other relevant circumstances. For assets under insurance contracts and reinsurance contracts issued, an insurer might conclude that it needs to distinguish:

- (a) deferred acquisition costs; and
- (b) intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.

IG23A Paragraph 14 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose the carrying amount of financial assets pledged as collateral for liabilities, the carrying amount of financial assets pledged as collateral for contingent liabilities, and any terms and conditions relating to assets pledged as collateral. In complying with this requirement, an insurer might also conclude that it needs to disclose segregation requirements that are intended to protect policyholders by restricting the use of some of the insurer's assets.

IG24 IAS 1 lists minimum line items that an entity should present in its statement of comprehensive income. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. An insurer might conclude that, to satisfy these requirements, it needs to present the following amounts in its statement of comprehensive income:

- (a) revenue from insurance contracts issued (without any reduction for reinsurance held).
- (b) income from contracts with reinsurers.
- (c) expense for policyholder claims and benefits (without any reduction for reinsurance held).
- (d) expenses arising from reinsurance held.

IG25 ~~IAS 18~~IFRS 15 requires an entity to ~~disclose the amount of each significant category of revenue recognised during the period, and specifically requires disclosure of revenue arising from the rendering of services~~disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Although revenue from insurance contracts is outside the scope of IFRS 15~~IAS 18~~, similar disclosures may be appropriate for insurance contracts. The IFRS does not prescribe a particular method for recognising revenue and various models exist:

- (a) Under some models, an insurer recognises premiums earned during the period as revenue and recognises claims arising during the period (including estimates of claims incurred but not reported) as an expense.

- (b) Under some other models, an insurer recognises premiums received as revenue and at the same time recognises an expense representing the resulting increase in the insurance liability.
 - (c) Under yet other models, an insurer recognises premiums received as deposit receipts. Its revenue includes charges for items such as mortality, and its expenses include the policyholder claims and benefits related to those charges.
- IG26 IAS 1 requires additional disclosure of various items of income and expense. An insurer might conclude that, to satisfy these requirements, it needs to disclose the following additional items, either in its statement of comprehensive income or in the notes:
- (a) acquisition costs (distinguishing those recognised as an expense immediately from the amortisation of deferred acquisition costs).
 - (b) the effect of changes in estimates and assumptions.
 - (c) losses recognised as a result of applying liability adequacy tests.
 - (d) for insurance liabilities measured on a discounted basis:
 - (i) accretion of interest to reflect the passage of time; and
 - (ii) the effect of changes in discount rates.
 - (e) distributions or allocations to holders of contracts that contain discretionary participation features. The portion of profit or loss that relates to any equity component of those contracts is an allocation of profit or loss, not expense or income (paragraph 34(c) of the IFRS).
- IG27 Some insurers present a detailed analysis of the sources of their earnings from insurance activities either in the statement of comprehensive income, or in the notes. Such an analysis may provide useful information about both the income and expense of the current period and the risk exposures faced during the period.
- IG28 The items described in paragraph IG26 are not offset against income or expense arising from reinsurance held (paragraph 14(d)(ii) of the IFRS).
- IG29 Paragraph 37(b) also requires specific disclosure about gains or losses recognised on buying reinsurance. This disclosure informs users about gains or losses that may, using some measurement models, arise from imperfect measurements of the underlying direct insurance liability. Furthermore, some measurement models require a cedant to defer some of those gains and losses and amortise them over the period of the related risk exposures, or some other period. Paragraph 37(b) also requires a cedant to disclose information about such deferred gains and losses.
- IG30 If an insurer does not adopt uniform accounting policies for the insurance liabilities of its subsidiaries, it might conclude that it needs to disaggregate the disclosures about amounts reported in its financial statements to give meaningful information about amounts determined using different accounting policies.

Significant assumptions and other sources of estimation uncertainty

- IG31 Paragraph 37(c) of the IFRS requires an insurer to describe the process used to determine the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts and, when practicable, give quantified disclosure of those assumptions. For some disclosures, such as discount rates or assumptions about future trends or general inflation, it may

be relatively easy to disclose the assumptions used (aggregated at a reasonable but not excessive level, when necessary). For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, in which case it is more important to describe the process used to generate the assumptions.

IG32 The description of the process used to determine assumptions might include a summary of the most significant of the following:

- (a) the objective of the assumptions. For example, an insurer might disclose whether the assumptions are intended to be neutral estimates of the most likely or expected outcome ('best estimates') or to provide a given level of assurance or level of sufficiency. If they are intended to provide a quantitative or qualitative level of assurance, an insurer might disclose that level.
- (b) the source of data used as inputs for the assumptions that have the greatest effect. For example, an insurer might disclose whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, an insurer might disclose the criteria used to determine when the studies are updated and the date of the latest update.
- (c) the extent to which the assumptions are consistent with observable market prices or other published information.
- (d) a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions. If a relationship would normally be expected between experience and future results, an insurer might explain the reasons for using assumptions that differ from past experience and indicate the extent of the difference.
- (e) a description of how the insurer developed assumptions about future trends, such as changes in mortality, healthcare costs or litigation awards.
- (f) an explanation of how the insurer identifies correlations between different assumptions.
- (g) the insurer's policy in making allocations or distributions for contracts with discretionary participation features, the related assumptions that are reflected in the financial statements, the nature and extent of any significant uncertainty about the relative interests of policyholders and shareholders in the unallocated surplus associated with those contracts, and the effect on the financial statements of any changes during the period in that policy or those assumptions.
- (h) the nature and extent of uncertainties affecting specific assumptions. In addition, to comply with paragraphs 125-131 of IAS 1, an insurer may need to disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions could require a material adjustment to the carrying amount of insurance liabilities and insurance assets. Paragraph 129 of IAS 1 gives further guidance on this disclosure.

IG33 The IFRS does not prescribe specific assumptions that would be disclosed, because different assumptions will be more significant for different types of contract.

Changes in assumptions

IG34 Paragraph 37(d) of the IFRS requires an insurer to disclose the effect of changes in assumptions used to measure insurance assets and insurance liabilities. This is consistent with IAS 8, which requires disclosure of the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods.

- IG35 Assumptions are often interdependent. When this is the case, analysis of changes by assumption may depend on the order in which the analysis is performed and may be arbitrary to some extent. Therefore, the IFRS does not specify a rigid format or content for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for their particular circumstances. If practicable, an insurer might disclose separately the impact of changes in different assumptions, particularly if changes in some assumptions have an adverse effect and others have a beneficial effect. An insurer might also describe the impact of interdependencies between assumptions and the resulting limitations of any analysis of the effect of changes in assumption.
- IG36 An insurer might disclose the effects of changes in assumptions both before and after reinsurance held, especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.

Changes in insurance liabilities and related items

- IG37 Paragraph 37(e) of the IFRS requires an insurer to disclose reconciliations of changes in insurance liabilities. It also requires disclosure of changes in reinsurance assets. An insurer need not disaggregate those changes into broad classes, but might do that if different forms of analysis are more relevant for different types of liability. The changes might include:
- (a) the carrying amount at the beginning and end of the period.
 - (b) additional insurance liabilities arising during the period.
 - (c) cash paid.
 - (d) income and expense included in profit or loss.
 - (e) liabilities acquired from, or transferred to, other insurers.
 - (f) net exchange differences arising on the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity.
- IG38 An insurer discloses the changes in insurance liabilities and reinsurance assets in all prior periods for which it reports full comparative information.
- IG39 Paragraph 37(e) of the IFRS also requires an insurer to disclose changes in deferred acquisition costs, if applicable. The reconciliation might disclose:
- (a) the carrying amount at the beginning and end of the period.
 - (b) the amounts incurred during the period.
 - (c) the amortisation for the period.
 - (d) impairment losses recognised during the period.
 - (e) other changes categorised by cause and type.
- IG40 An insurer may have recognised intangible assets related to insurance contracts acquired in a business combination or portfolio transfer. IAS 38 *Intangible Assets* contains disclosure requirements for intangible assets, including a requirement to give a reconciliation of changes in intangible assets. The IFRS does not require additional disclosures about these assets.

Nature and extent of risks arising from insurance contracts (paragraphs 38-39A of the IFRS)

- IG41 The disclosures about the nature and extent of risks arising from insurance contracts are based on two foundations:
- (a) There should be a balance between quantitative and qualitative disclosures, enabling users to understand the nature of risk exposures and their potential impact.
 - (b) Disclosures should be consistent with how management perceives its activities and risks, and the objectives, policies and processes that management uses to manage those risks. This approach is likely:
 - (i) to generate information that has more predictive value than information based on assumptions and methods that management does not use, for instance, in considering the insurer's ability to react to adverse situations.
 - (ii) to be more effective in adapting to the continuing change in risk measurement and management techniques and developments in the external environment over time.
- IG42 In developing disclosures to satisfy paragraphs 38-39A of the IFRS, an insurer decides in the light of its circumstances how it would aggregate information to display the overall picture without combining information that has materially different characteristics, so that the information is useful. An insurer might group insurance contracts into broad classes appropriate for the nature of the information to be disclosed, taking into account matters such as the risks covered, the characteristics of the contracts and the measurement basis applied. The broad classes may correspond to classes established for legal or regulatory purposes, but the IFRS does not require this.
- IG43 Under IFRS 8 *Operating Segments*, the identification of reportable segments reflects the way in which management allocates resources and assesses performance. An insurer might adopt a similar approach to identify broad classes of insurance contracts for disclosure purposes, although it might be appropriate to disaggregate disclosures down to the next level. For example, if an insurer identifies life insurance as a reportable segment for IFRS 8, it might be appropriate to report separate information about, say, life insurance, annuities in the accumulation phase and annuities in the payout phase.
- IG44 [Deleted]
- IG45 In identifying broad classes for separate disclosure, an insurer might consider how best to indicate the level of uncertainty associated with the risks underwritten, to inform users whether outcomes are likely to be within a wider or a narrower range. For example, an insurer might disclose information about exposures where there are significant amounts of provisions for claims incurred but not reported (IBNR) or where outcomes and risks are unusually difficult to assess (eg asbestos).
- IG46 It may be useful to disclose sufficient information about the broad classes identified to permit a reconciliation to relevant line items in the statement of financial position.

- IG47 Information about the nature and extent of risks arising from insurance contracts is more useful if it highlights any relationship between classes of insurance contracts (and between insurance contracts and other items, such as financial instruments) that can affect those risks. If the effect of any relationship would not be apparent from disclosures required by the IFRS, further disclosure might be useful.

Risk management objectives and policies for mitigating risks arising from insurance contracts

- IG48 Paragraph 39(a) of the IFRS requires an insurer to disclose its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks. Such discussion provides an additional perspective that complements information about contracts outstanding at a particular time. Such disclosure might include information about:

- (a) the structure and organisation of the insurer's risk management function(s), including a discussion of independence and accountability.
- (b) the scope and nature of the insurer's risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing, and how the insurer integrates them into its operating activities. Useful disclosure might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach.
- (c) the insurer's processes for accepting, measuring, monitoring and controlling insurance risks and the underwriting strategy to ensure that there are appropriate risk classification and premium levels.
- (d) the extent to which insurance risks are assessed and managed on an entity-wide basis.
- (e) the methods the insurer employs to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance.
- (f) asset and liability management (ALM) techniques.
- (g) the insurer's processes for managing, monitoring and controlling commitments received (or given) to accept (or contribute) additional debt or equity capital when specified events occur.

These disclosures might be provided both for individual types of risks insured and overall, and might include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the insurance contracts and their relative significance to the insurer.

- IG49- [Deleted]
IG50

Insurance risk

- IG51 Paragraph 39(c) of the IFRS requires disclosures about insurance risk. Disclosures to satisfy this requirement might build on the following foundations:

- (a) Information about insurance risk might be consistent with (though less detailed than) the information provided internally to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management'.

- (b) Information about risk exposures might report exposures both gross and net of reinsurance (or other risk mitigating elements, such as catastrophe bonds issued or policyholder participation features), especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.
- (c) In reporting quantitative information about insurance risk, an insurer might disclose the methods used, the strengths and limitations of those methods, the assumptions made, and the effect of reinsurance, policyholder participation and other mitigating elements.
- (d) Insurers might classify risk along more than one dimension. For example, life insurers might classify contracts by both the level of mortality risk and the level of investment risk. It may sometimes be convenient to display this information in a matrix format.
- (e) If an insurer's risk exposures at the end of the reporting period are unrepresentative of its exposures during the period, it might be useful to disclose that fact.
- (f) The following disclosures required by paragraph 39 of the IFRS might also be relevant:
 - (i) the sensitivity of profit or loss and equity to changes in variables that have a material effect on them.
 - (ii) concentrations of insurance risk.
 - (iii) the development of prior year insurance liabilities.

IG51A Disclosures about insurance risk might include:

- (a) information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).
- (b) information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities, including the general nature of any formula for the participation and the extent of any discretion held by the insurer.
- (c) information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds (see also IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

Sensitivity to insurance risk

IG52 Paragraph 39(c)(i) of the IFRS requires disclosure about sensitivity to insurance risk. To permit meaningful aggregation, the sensitivity disclosures focus on summary indicators, namely profit or loss and equity. Although sensitivity tests can provide useful information, such tests have limitations. An insurer might disclose the strengths and limitations of sensitivity analyses performed.

IG52A Paragraph 39A permits two alternative approaches for this disclosure: quantitative disclosure of effects on profit or loss and equity (paragraph 39A(a)) or qualitative disclosure and disclosure about terms and conditions (paragraph 39A(b)). An insurer may provide quantitative disclosures for some insurance risks (in accordance with paragraph 39A(a)), and provide qualitative information about sensitivity and information about terms and conditions (in accordance with paragraph 39A(b)) for other insurance risks.

IG53 Informative disclosure avoids giving a misleading sensitivity analysis if there are significant non-linearities in sensitivities to variables that have a material effect. For example, if a change of 1 per cent in a variable has a negligible effect, but a change of 1.1 per cent has a material effect, it might be misleading to disclose the effect of a 1 per cent change without further explanation.

IG53A If an insurer chooses to disclose a quantitative sensitivity analysis in accordance with paragraph 39A(a), and that sensitivity analysis does not reflect significant correlations between key variables, the insurer might explain the effect of those correlations.

IG54 [Deleted]

IG54A If an insurer chooses to disclose qualitative information about sensitivity in accordance with paragraph 39A(b), it is required to disclose information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of cash flows. To achieve this, an insurer might disclose the qualitative information suggested by paragraphs IG51-IG58 on insurance risk and paragraphs IG62-IG65G on credit risk, liquidity risk and market risk. As stated in paragraph IG12, an insurer decides in the light of its circumstances how it aggregates information to display the overall picture without combining information with different characteristics. An insurer might conclude that qualitative information needs to be more disaggregated if it is not supplemented with quantitative information.

Concentrations of insurance risk

IG55 Paragraph 39(c)(ii) of the IFRS refers to the need to disclose concentrations of insurance risk. Such concentration could arise from, for example:

- (a) a single insurance contract, or a small number of related contracts, for instance, when an insurance contract covers low-frequency, high-severity risks such as earthquakes.
- (b) single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability.
- (c) exposure to unexpected changes in trends, for example, unexpected changes in human mortality or in policyholder behaviour.
- (d) exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses.
- (e) significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts.
- (f) correlations and interdependencies between different risks.
- (g) significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows.
- (h) geographical and sectoral concentrations.

- IG56 Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic.
- IG57 Disclosure about an insurer's historical performance on low-frequency, high-severity risks might be one way to help users to assess cash flow uncertainty associated with those risks. Consider an insurance contract that covers an earthquake that is expected to happen every 50 years, on average. If the insured event occurs during the current contract period, the insurer will report a large loss. If the insured event does not occur during the current period, the insurer will report a profit. Without adequate disclosure of the source of historical profits, it could be misleading for the insurer to report 49 years of reasonable profits, followed by one large loss; users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, it might be useful to describe the extent of the exposure to risks of this kind and the estimated frequency of losses. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies.
- IG58 For regulatory or other reasons, some entities produce special purpose financial reports that show catastrophe or equalisation reserves as liabilities. However, in financial statements prepared using IFRSs, those reserves are not liabilities but are a component of equity. Therefore they are subject to the disclosure requirements in IAS 1 for equity. IAS 1 requires an entity to disclose:
- (a) a description of the nature and purpose of each reserve within equity;
 - (b) information that enables users to understand the entity's objectives, policies and processes for managing capital; and
 - (c) the nature of any externally imposed capital requirements, how those requirements are incorporated into the management of capital and whether during the period it complied with any externally imposed capital requirements to which it is subject.

Claims development

- IG59 Paragraph 39(c)(iii) of the IFRS requires disclosure of claims development information (subject to transitional relief in paragraph 44). Informative disclosure might reconcile this information to amounts reported in the statement of financial position. An insurer might disclose unusual claims expenses or developments separately, allowing users to identify the underlying trends in performance.
- IG60 As explained in paragraph 39(c)(iii) of the IFRS, disclosures about claims development are not required for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year. Therefore, these disclosures are not normally required for most life insurance contracts. Furthermore, claims development disclosure is not normally needed for annuity contracts because each periodic payment arises, in effect, from a separate claim about which there is no uncertainty.
- IG61 IG Example 5 shows one possible format for presenting claims development information. Other possible formats might, for example, present information by accident year rather than underwriting year. Although the example illustrates a format that might be useful if insurance liabilities are discounted, the IFRS does not require discounting (paragraph 25(a) of the IFRS).

IG Example 5: Disclosure of claims development

This example illustrates a possible format for a claims development table for a general insurer. The top half of the table shows how the insurer's estimates of total claims for each underwriting year develop over time. For example, at the end of 20X1, the insurer estimated that it would pay claims of CU680 for insured events relating to insurance contracts underwritten in 20X1. By the end of 20X2, the insurer had revised the estimate of cumulative claims (both those paid and those still to be paid) to CU673.

The lower half of the table reconciles the cumulative claims to the amount appearing in the statement of financial position. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, if the claims liabilities are discounted, the effect of discounting is deducted to give the carrying amount in the statement of financial position.

<i>Underwriting</i> Year	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU	Total CU
Estimate of cumulative claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative Payments	<u>(702)</u>	<u>(689)</u>	<u>(570)</u>	<u>(350)</u>	<u>(217)</u>	
	-	82	275	553	751	1,661
Effect of discounting	<u>-</u>	<u>(14)</u>	<u>(68)</u>	<u>(175)</u>	<u>(285)</u>	<u>(542)</u>
Present value recognised in the statement of financial position	<u>-</u>	<u>68</u>	<u>207</u>	<u>378</u>	<u>466</u>	<u>1,119</u>

Credit risk, liquidity risk and market risk

IG62 Paragraph 39(d) of the IFRS requires an insurer to disclose information about credit risk, liquidity risk and market risk that paragraphs 31-42 of IFRS 7 would require if insurance contracts were within its scope. Such disclosure includes:

- (a) summary quantitative data about the insurer's exposure to those risks based on information provided internally to its key management personnel (as defined in IAS 24); and
- (b) to the extent not already covered by the disclosures discussed above, the information described in paragraphs 36-42 of IFRS 7.

The disclosures about credit risk, liquidity risk and market risk may be either provided in the financial statements or incorporated by cross-reference to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time.

IG63 [Deleted]

IG64 Informative disclosure about credit risk, liquidity risk and market risk might include:

- (a) information about the extent to which features such as policyholder participation features mitigate or compound those risks.
- (b) a summary of significant guarantees, and of the levels at which guarantees of market prices or interest rates are likely to alter the insurer's cash flows.
- (c) the basis for determining investment returns credited to policyholders, such as whether the returns are fixed, based contractually on the return of specified assets or partly or wholly subject to the insurer's discretion.

Credit risk

IG64A Paragraphs 36-38 of IFRS 7 require disclosure about credit risk. Credit risk is defined as 'the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss'. Thus, for an insurance contract, credit risk includes the risk that an insurer incurs a financial loss because a reinsurer defaults on its obligations under the reinsurance contract. Furthermore, disputes with the reinsurer could lead to an impairment of the cedant's reinsurance asset. The risk of such disputes may have an effect similar to credit risk. Thus, similar disclosure might be relevant. Balances due from agents or brokers may also be subject to credit risk.

IG64B A financial guarantee contract reimburses a loss incurred by the holder because a specified debtor fails to make payment when due. The holder is exposed to credit risk, and IFRS 7 requires the holder to provide disclosures about that credit risk. However, from the perspective of the issuer, the risk assumed by the issuer is insurance risk rather than credit risk.

IG65 [Deleted]

IG65A The issuer of a financial guarantee contract provides disclosures complying with IFRS 7 if it applies IFRS 9~~IAS 39~~ in recognising and measuring the contract. If the issuer elects, when permitted by paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring the contract, it provides disclosures complying with IFRS 4. The main implications are as follows:

- (a) IFRS 4 requires disclosure about actual claims compared with previous estimates (claims development), but does not require disclosure of the fair value of the contract.
- (b) IFRS 7 requires disclosure of the fair value of the contract, but does not require disclosure of claims development.

Liquidity risk

IG65B Paragraph 39(a) and (b) of IFRS 7 requires disclosure of a maturity analysis for financial liabilities that shows the remaining contractual maturities. For insurance contracts, the contractual maturity refers to the estimated date when contractually required cash flows will occur. This depends on factors such as when the insured event occurs and the possibility of lapse. However, IFRS 4 permits various existing accounting practices for insurance contracts to continue. As a result, an insurer may not need to make detailed estimates of cash flows to determine the amounts it recognises in the statement of financial position. To avoid requiring detailed cash flow estimates that are not required for measurement purposes, paragraph 39(d)(i) of IFRS 4 states that an insurer need not provide the maturity analyses required by paragraph 39(a) and (b) of IFRS 7 (ie that shows the remaining contractual maturities of insurance contracts) if it discloses an analysis, by estimated timing, of the amounts recognised in the statement of financial position.

IG65C An insurer might also disclose a summary narrative description of how the maturity analysis (or analysis by estimated timing) flows could change if policyholders exercised lapse or surrender options in different ways. If an insurer considers that lapse behaviour is likely to be sensitive to interest rates, the insurer might disclose that fact and state whether the disclosures about market risk reflect that interdependence.

Market risk

IG65D Paragraph 40(a) of IFRS 7 requires a sensitivity analysis for each type of market risk at the end of the reporting period, showing the effect of reasonably possible changes in the relevant risk variable on profit or loss or equity. If no reasonably possible change in the relevant risk variable would affect profit or loss or equity, an entity discloses that fact to comply with paragraph 40(a) of IFRS 7. A reasonably possible change in the relevant risk variable might not affect profit or loss in the following examples:

- (a) if a non-life insurance liability is not discounted, changes in market interest rates would not affect profit or loss.
- (b) some insurers may use valuation factors that blend together the effect of various market and non-market assumptions that do not change unless the insurer assesses that its recognised insurance liability is not adequate. In some cases a reasonably possible change in the relevant risk variable would not affect the adequacy of the recognised insurance liability.

IG65E In some accounting models, a regulator specifies discount rates or other assumptions about market risk variables that the insurer uses in measuring its insurance liabilities and the regulator does not amend those assumptions to reflect current market conditions at all times. In such cases, the insurer might comply with paragraph 40(a) of IFRS 7 by disclosing:

- (a) the effect on profit or loss or equity of a reasonably possible change in the assumption set by the regulator.
- (b) the fact that the assumption set by the regulator would not necessarily change at the same time, by the same amount, or in the same direction, as changes in market prices, or market rates, would imply.

IG65F An insurer might be able to take action to reduce the effect of changes in market conditions. For example, an insurer may have discretion to change surrender values or maturity benefits, or to vary the amount or timing of policyholder benefits arising from discretionary participation features. Paragraph 40(a) of IFRS 7 does not require entities to consider the potential effect of future management actions that may offset

the effect of the disclosed changes in the relevant risk variable. However, paragraph 40(b) of IFRS 7 requires an entity to disclose the methods and assumptions used to prepare the sensitivity analysis. To comply with this requirement, an insurer might conclude that it needs to disclose the extent of available management actions and their effect on the sensitivity analysis.

IG65G Some insurers manage sensitivity to market conditions using a method that differs from the method described by paragraph 40(a) of IFRS 7. For example, some insurers use an analysis of the sensitivity of embedded value to changes in market risk. Paragraph 39(d)(ii) of IFRS 4 permits an insurer to use that sensitivity analysis to meet the requirement in paragraph 40(a) of IFRS 7. IFRS 4 and IFRS 7 require an insurer to provide sensitivity analyses for all classes of financial instruments and insurance contracts, but an insurer might use different approaches for different classes. IFRS 4 and IFRS 7 specify the following approaches:

- (a) the sensitivity analysis described in paragraph 40(a) of IFRS 7 for financial instruments or insurance contracts;
- (b) the method described in paragraph 41 of IFRS 7 for financial instruments or insurance contracts; or
- (c) the method permitted by paragraph 39(d)(ii) of IFRS 4 for insurance contracts.

Exposures to market risk under embedded derivatives

IG66 Paragraph 39(e) of the IFRS requires an insurer to disclose information about exposures to market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivative at fair value (for example, guaranteed annuity options and guaranteed minimum death benefits).

IG67 An example of a contract containing a guaranteed annuity option is one in which the policyholder pays a fixed monthly premium for thirty years. At maturity, the policyholder can elect to take either (a) a lump sum equal to the accumulated investment value or (b) a lifetime annuity at a rate guaranteed at inception (ie when the contract started). For policyholders electing to receive the annuity, the insurer could suffer a significant loss if interest rates decline substantially or if the policyholder lives much longer than the average. The insurer is exposed to both market risk and significant insurance risk (mortality risk) and a transfer of insurance risk occurs at inception, because the insurer fixed the price for mortality risk at that date. Therefore, the contract is an insurance contract from inception. Moreover, the embedded guaranteed annuity option itself meets the definition of an insurance contract, and so separation is not required.

IG68 An example of a contract containing minimum guaranteed death benefits is one in which the policyholder pays a monthly premium for 30 years. Most of the premiums are invested in a mutual fund. The rest is used to buy life cover and to cover expenses. On maturity or surrender, the insurer pays the value of the mutual fund units at that date. On death before final maturity, the insurer pays the greater of (a) the current unit value and (b) a fixed amount. This contract could be viewed as a hybrid contract comprising (a) a mutual fund investment and (b) an embedded life insurance contract that pays a death benefit equal to the fixed amount less the current unit value (but zero if the current unit value is more than the fixed amount).

IG69 Both these embedded derivatives meet the definition of an insurance contract if the insurance risk is significant. However, in both cases market risk may be much more significant than the mortality risk. If interest rates or equity markets fall substantially, these guarantees would be well in the money. Given the long-term nature of the guarantees and the size of the exposures, an insurer might face extremely large

losses. Therefore, an insurer might place particular emphasis on disclosures about such exposures.

IG70 Useful disclosures about such exposures might include:

- (a) the sensitivity analysis discussed above.
- (b) information about the levels where these exposures start to have a material effect on the insurer's cash flows (paragraph IG64(b)).
- (c) the fair value of the embedded derivative, although neither the IFRS nor IFRS 7 requires disclosure of that fair value.

Key performance indicators

IG71 Some insurers present disclosures about what they regard as key performance indicators, such as lapse and renewal rates, total sum insured, average cost per claim, average number of claims per contract, new business volumes, claims ratio, expense ratio and combined ratio. The IFRS does not require such disclosures. However, such disclosures might be a useful way for an insurer to explain its financial performance during the period and to give an insight into the risks arising from insurance contracts.

HKFRS 5
Revised ~~December 2016~~ September 2018

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Financial Reporting Standard 5

Non-current Assets Held for Sale and Discontinued Operations



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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The requirements for measuring the individual assets and liabilities within the disposal group are set out in paragraphs 18, 19 and 23.

- 5 The measurement provisions of this HKFRS* do not apply to the following assets, which are covered by the HKFRSs listed, either as individual assets or as part of a disposal group:
- (a) deferred tax assets (HKAS 12 *Income Taxes*).
 - (b) assets arising from employee benefits (HKAS 19 *Employee Benefits*).
 - (c) financial assets within the scope of ~~HKAS 39~~ HKFRS 9 *Financial Instruments: Recognition and Measurement*.
 - (d) non-current assets that are accounted for in accordance with the fair value model in HKAS 40 *Investment Property*.
 - (e) non-current assets that are measured at fair value less costs to sell in accordance with HKAS 41 *Agriculture*.
 - (f) contractual rights under insurance contracts as defined in HKFRS 4 *Insurance Contracts*.
- 5A[‡] The classification, presentation and measurement requirements in this HKFRS applicable to a non-current asset (or disposal group) that is classified as held for sale apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners (held for distribution to owners).
- 5B[†] This HKFRS specifies the disclosures required in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations. Disclosures in other HKFRSs do not apply to such assets (or disposal groups) unless those HKFRSs require:
- (a) specific disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations; or
 - (b) disclosures about measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of HKFRS 5 and such disclosure are not already provided in the other notes to the financial statements.

Additional disclosures about non-current assets (or disposal groups) classified as held for sale or discontinued operations may be necessary to comply with the general requirements of HKAS 1, in particular paragraphs 15 and 125 of that Standard.

Classification of non-current assets (or disposal groups) as held for sale or as held for distribution to owners

- 6 An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.**

* Other than paragraphs 18 and 19, which require the assets in question to be measured in accordance with other applicable HKFRSs.

[‡] Effective for annual periods beginning on or after 1 July 2009.

[†] Effective for annual periods beginning on or after 1 January 2010.

- 34 An entity shall re-present the disclosures in paragraph 33 for prior periods presented in the financial statements so that the disclosures relate to all operations that have been discontinued by the end of the reporting period for the latest period presented.
- 35 Adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period shall be classified separately in discontinued operations. The nature and amount of such adjustments shall be disclosed. Examples of circumstances in which these adjustments may arise include the following:
- (a) the resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser.
 - (b) the resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller.
 - (c) the settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction.
- 36 If an entity ceases to classify a component of an entity as held for sale, the results of operations of the component previously presented in discontinued operations in accordance with paragraphs 33-35 shall be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods shall be described as having been re-presented.
- 36A* An entity that is committed to a sale plan involving loss of control of a subsidiary shall disclose the information required in paragraphs 33-36 when the subsidiary is a disposal group that meets the definition of a discontinued operation in accordance with paragraph 32.

Gains or losses relating to continuing operations

- 37 Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations.

Presentation of a non-current asset or disposal group classified as held for sale

- 38 An entity shall present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held for sale shall be presented separately from other liabilities in the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either in the statement of financial position or in the notes, except as permitted by paragraph 39. An entity shall present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale.

* Effective for annual periods beginning on or after 1 July 2009.

an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

- 44B HKAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) added paragraph 33(d). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendment shall be applied for that earlier period. The amendment shall be applied retrospectively.
- 44C Paragraphs 8A and 36A were added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. Earlier application is permitted. However, an entity shall not apply the amendments for annual periods beginning before 1 July 2009 unless it also applies HKAS 27 (as amended in March 2008). If an entity applies the amendments before 1 July 2009 it shall disclose that fact. An entity shall apply the amendments prospectively from the date at which it first applied HKFRS 5, subject to the transitional provisions in paragraph 45 of HKAS 27 (amended March 2008).
- 44D Paragraphs 5A, 12A and 15A were added and paragraph 8 was amended by Hong Kong (IFRIC) Interpretation 17 *Distributions of Non-cash Assets to Owners* in December 2008. Those amendments shall be applied prospectively to non-current assets (or disposal groups) that are classified as held for distribution to owners in annual periods beginning on or after 1 July 2009. Retrospective application is not permitted. Earlier application is permitted. If an entity applies the amendments for a period beginning before 1 July 2009 it shall disclose that fact and also apply HKFRS 3 *Business Combinations* (as revised in 2008), HKAS 27 (as amended in March 2008) and Hong Kong (IFRIC) Interpretation 17.
- 44E Paragraph 5B was added by *Improvements to HKFRSs* issued in May 2009. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 44F ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~[Deleted]
- 44G HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraph 28. An entity shall apply that amendment when it applies HKFRS 11.
- 44H HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended the definition of fair value in Appendix A. An entity shall apply that amendment when it applies HKFRS 13.
- 44I *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 33A. An entity shall apply that amendment when it applies HKAS 1 as amended in July 2011.
- 44J ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~[Deleted]
- 44K ~~[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]~~HKFRS 9, as issued in September 2014, amended paragraph 5 and deleted paragraphs 44F and 44J. An entity shall apply those amendments when it applies HKFRS 9.

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 5*

Non-current Assets Held for Sale and Discontinued Operations



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- BC7 The Board published its proposals in an Exposure Draft, ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations*, in July 2003 with a comment deadline of 24 October 2003. The Board received over 80 comment letters on the Exposure Draft.

Scope of the IFRS

- BC8 In ED 4, the Board proposed that the IFRS should apply to all non-current assets except:
- (a) goodwill,
 - (b) financial instruments within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*,^{*}
 - (c) financial assets under leases, and
 - (d) deferred tax assets and assets arising from employee benefits.
- BC9 In reconsidering the scope, the Board noted that the use of the term ‘non-current’ caused the following problems:
- (a) assets that are acquired with the intention of resale were clearly intended to be within the scope of ED 4, but would also be within the definition of current assets and so might be thought to be excluded. The same was true for assets that had been classified as non-current but were now expected to be realised within twelve months.
 - (b) it was not clear how the scope would apply to assets presented in accordance with a liquidity presentation.
- BC10 The Board noted that it had not intended that assets classified as non-current in accordance with IAS 1 *Presentation of Financial Statements* would be reclassified as current assets simply because of management’s intention to sell or because they reached their final twelve months of expected use by the entity. The Board decided to clarify in IFRS 5 that assets classified as non-current are not reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with the IFRS. Further, assets of a class that an entity would normally regard as non-current and are acquired exclusively with a view to resale are not classified as current unless they meet the criteria to be classified as held for sale in accordance with the IFRS.
- BC11 In relation to assets presented in accordance with a liquidity presentation, the Board decided that non-current should be taken to mean assets that include amounts expected to be recovered more than twelve months after the balance sheet date.
- BC12 These clarifications ensure that all assets of the type normally regarded by the entity as non-current will be within the scope of the IFRS.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

BC13 The Board also reconsidered the exclusions from the scope proposed in ED 4. The Board noted that the classification and presentation requirements of the IFRS are applicable to all non-current assets and concluded that any exclusions should relate only to the measurement requirements. In relation to the measurement requirements, the Board decided that non-current assets should be excluded only if (i) they are already carried at fair value with changes in fair value recognised in profit or loss or (ii) there would be difficulties in determining their fair value less costs to sell. The Board therefore concluded that only the following non-current assets should be excluded from the measurement requirements of the IFRS:

Assets already carried at fair value with changes in fair value recognised in profit or loss:

- (a) financial assets within the scope of IAS 39.^{*}
- (b) non-current assets that have been accounted for using the fair value model in IAS 40 *Investment Property*.
- (c) non-current assets that have been measured at fair value less estimated point-of-sale costs in accordance with IAS 41 *Agriculture*.[†]

Assets for which there might be difficulties in determining their fair value:

- (a) deferred tax assets.
- (b) assets arising from employee benefits.
- (c) assets arising from insurance contracts.

BC14 The Board acknowledged that the scope of the IFRS would differ from that of SFAS 144 but noted that SFAS 144 covers the impairment of non-current assets held for use as well as those held for sale. Furthermore, other requirements in US GAAP affect the scope of SFAS 144. The Board therefore concluded that convergence with the scope of SFAS 144 would not be possible.

BC14A The Board identified a need to clarify the disclosure requirements for non-current assets (or disposal groups) classified as held for sale or discontinued operations in accordance with IFRS 5. Some believed that IFRS 5 and other IFRSs that specifically refer to non-current assets (or disposal groups) classified as held for sale or discontinued operations set out all the disclosures required in respect of those assets or operations. Others believed that all disclosures required by IFRSs whose scope does not specifically exclude non-current assets (or disposal groups) classified as held for sale or discontinued operations apply to such assets (or disposal groups).[‡]

BC14B The Board noted that paragraph 30 of IFRS 5 requires an entity to ‘present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).’ Paragraph BC17 below states that ‘the Board concluded that

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

[†] In *Improvements to IFRSs* issued in May 2008 the Board amended IAS 41 : the term ‘estimated point-of-sale costs’ was replaced by ‘costs to sell’. IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

[‡] Paragraphs BC14A-BC14E were added as a consequence of amendments to IFRS 5 by *Improvements to IFRSs* issued in April 2009.

- BC53 The Board agreed that all subsidiaries should be consolidated and that all assets (and disposal groups) that meet the criteria to be classified as held for sale should be treated in the same way. The exemption from consolidation in IAS 27 *Consolidated and Separate Financial Statements* for subsidiaries acquired and held exclusively with a view to resale prevents those assets and disposal groups within such subsidiaries that meet the criteria to be classified as held for sale from being treated consistently with other assets and disposal groups. ED 4 therefore proposed that the exemption in IAS 27 should be removed.[#]
- BC54 Some respondents disagreed with this proposal, on the grounds that the information provided by consolidation of such subsidiaries would be less useful than that provided by the current requirement to measure the investment in such subsidiaries at fair value. The Board noted that the impact of the proposals in ED 4 would be limited to the following:
- (a) the measurement of a subsidiary that currently is within the scope of the exemptions would change from fair value as required by IAS 39[∇] to the lower of cost and fair value less costs to sell.
 - (b) any change in fair value of the investment in the subsidiary would, in accordance with the current requirements in IAS 27, be presented as a single amount in profit or loss as a held-for-trading financial asset[&] in accordance with IAS 39. As discussed in paragraph BC72, the subsidiary would be a discontinued operation and, in accordance with the IFRS's requirements (see paragraphs BC73-BC76), any recognised change in the value of the disposal group that comprises the subsidiary would be presented as a single amount in profit or loss.
 - (c) the presentation in the balance sheet would change from a single amount for the investment in the subsidiary to two amounts—one for the assets and one for the liabilities of the disposal group that is the subsidiary.^{*}
- BC55 The Board reaffirmed its conclusion set out in paragraph BC 53. However, it noted that the limited impact of the proposals apply only to the amounts required to be presented on the face of the balance sheet and the income statement. Providing the required analyses of those amounts in the notes could potentially involve the entity having to obtain significantly more information. The Board therefore decided not to require the disclosure of the analyses of the amounts presented on the face of the balance sheet and income statement for newly acquired subsidiaries and to clarify in an example the computational short cuts that could be used to arrive at the amounts to be presented on the face of the balance sheet and income statement.

Presentation of non-current assets held for sale

BC56 SFAS 144 requires an entity to present:

- (a) a long-lived asset classified as held for sale separately in the balance sheet; and

[#] The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. IFRS 10 does not contain an exception from consolidation for subsidiaries acquired and held exclusively with a view to resale.

[∇] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

[&] IFRS 9 *Financial Instruments* eliminated the category of held-for-trading financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

^{*} Greater disaggregation of the disposal group in the statement of financial position is permitted but not required.

- (b) the assets and liabilities of a disposal group classified as held for sale separately in the asset and liability sections of the balance sheet. The major classes of those assets and liabilities are separately disclosed either on the face of the balance sheet or in the notes.

- BC57 In the Basis for Conclusions on SFAS 144 the FASB noted that information about the nature of both assets and liabilities of a disposal group is useful to users. Separately presenting those items in the balance sheet provides information that is relevant. Separate presentation also distinguishes those assets that are not being depreciated from those that are being depreciated. The Board agreed with the FASB's views.
- BC58 Respondents to ED 4 noted that the separate presentation within equity of amounts relating to assets and disposal groups classified as held for sale (such as, for example, unrealised gains and losses on available-for-sale assets^{*} and foreign currency translation adjustments) would also provide useful information. The Board agreed and has added such a requirement to the IFRS.

Timing of classification as, and definition of, discontinued operations

- BC59 With the introduction of SFAS 144, the FASB broadened the scope of a discontinued operation from a 'segment of a business' to a 'component of an entity'. A component is widely drawn, the criterion being that it comprises 'operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity'. SFAS 144 states that a component may be a segment, a reporting unit, a subsidiary or an asset group.
- BC60 However, at the same time, the FASB specified more restrictive criteria for determining *when* the component is classified as discontinued and hence when its results are presented as discontinued. SFAS 144 requires a component to be classified as discontinued only if it has been disposed of or if it meets the criteria for classification as an asset 'held for sale'.
- BC61 The definition of a discontinuing operation in IAS 35 as a 'major line of business' or 'geographical area of operations' is closer to the former, and narrower, US GAAP definition. The trigger in IAS 35 for classifying the operation as discontinuing is the earlier of (a) the entity entering into a binding sale agreement and (b) the board of directors approving and announcing a formal disposal plan. Although IAS 35 refers to IAS 37 for further guidance on what constitutes a plan, the criteria are less restrictive than those in SFAS 144.
- BC62 Paragraph 12 of the *Framework*[#] states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. Paragraph 15 of the *Framework* goes on to state that the economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents. Separately highlighting the results of discontinued operations provides users with information that is relevant in assessing the ongoing ability of the entity to generate cash flows.

* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statement*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 12 and 15 were superseded by Chapter 1 of the *Conceptual Framework*.

- BC63 In terms of the timing of classifying an operation as discontinued, the Board considered whether more useful information is provided by making the classification conditional upon a firm decision to discontinue an operation (the current IAS 35 approach) or conditional upon the classification of an operation as held for sale.
- BC64 The Board decided that, to be consistent with the presentation of assets held for disposal and in the interests of convergence, an operation should be classified as discontinued when it is disposed of or classified as held for sale.
- BC65 IAS 35 also adopts a different approach from US GAAP when criteria for classification as discontinued are met after the period-end but before the financial statements are issued. SFAS 144 requires some disclosure; however, the component is *not* presented as a discontinued operation. IAS 35 requires the component to be classified as discontinuing.
- BC66 The Board believes that, consistently with IAS 10 *Events after the Balance Sheet Date*^{*}, a component should not be classified as discontinued in the financial statements unless it meets the criteria to be so classified at the balance sheet date.
- BC67 In terms of the definition of a discontinued operation, ED 4 proposed adopting the SFAS 144 definition of a discontinued operation. The Board argued that under existing IAS 35 there may be disposal transactions that, although likely to have an impact on the ongoing operations of the entity, do not meet the criteria for classification as a discontinuing activity. For example, an entity might dispose of a significant portion, but not all, of its cash-generating units operating in a particular geographical area. Under IAS 35, that might not meet the definition of a discontinuing operation. Under SFAS 144, if the relevant criteria were met, it would.
- BC68 However, a substantial majority of respondents to ED 4 disagreed with this proposal. They preferred instead to retain the IAS 35 criterion that a discontinued operation should be a major line of business or geographical area of operations.
- BC69 The Board reconsidered the issue in the light of the comments received and concluded that the size of unit that could be classified as discontinued in accordance with SFAS 144 was too small, with the result that the information provided by separately presenting discontinued operations may not be as useful as it could be.
- BC70 The Board also noted that the FASB Emerging Issues Task Force (EITF) is considering practical problems that have arisen in implementing the criteria for discontinued operations in SFAS 144. Specifically, the EITF is considering (a) the cash flows of the component that should be considered in the determination of whether cash flows have been or will be eliminated from the ongoing operations of the entity and (b) the types of continuing involvement that constitute significant continuing involvement in the operations of the disposal component. As a result of these practical problems, the Board further concluded that it was not appropriate to change the definition of a discontinued operation in a way that was likely to cause the same problems in practice as have arisen under SFAS 144.
- BC71 The Board therefore decided that it would retain the requirement in IAS 35 that a discontinued operation should be a major line of business or geographical area of

* In September 2007 the title of IAS 10 was amended from *Events after the Balance Sheet Date* to *Events after the Reporting Period* as a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007.

operations, noting that this will include operations that would have been excluded from the US definition before SFAS 144, which was based on a reporting segment. However, the Board regards this as an interim measure and intends to work with the FASB to arrive at a converged definition within a relatively short time.

BC72 Lastly, the Board considered whether newly acquired subsidiaries that meet the criteria to be classified as held for sale should always be classified as discontinued. The Board concluded that they should be so classified because they are being disposed of for one of the following reasons:

- (a) the subsidiary is in a different line of business from the entity, so disposing of it is similar to disposing of a major line of business.
- (b) the subsidiary is required to be disposed of by regulators because the entity would otherwise have too much of a particular type of operation in a particular geographical area. In such a case the subsidiary must be a significant operation.

Changes to a plan of sale (amendment 2011)

BC72A During its redeliberation of the exposure draft ED 9 *Joint Arrangements* the Board decided that if a disposal group or non-current asset that ceases to be classified as held for sale is a subsidiary, a joint operation, a joint venture, an associate, or a portion of an interest in a joint venture or associate, an entity should amend its financial statements for the periods since the classification as held for sale was made.

Changes to a plan of sale or to a plan of distribution to owners

BC72B The Board received a request to clarify the accounting for a change in a disposal plan from a plan to sell to a plan to distribute a dividend in kind to its shareholders. Paragraph 26 of IFRS 5 was interpreted by some, but not all, as requiring this change to be considered as a change to a plan of sale that would be accounted for in accordance with paragraphs 27–29 of IFRS 5.

BC72C In analysing this issue the Board observed that there was no specific guidance in IFRS 5 for the discontinuation of held-for-distribution accounting, when an entity determines that the asset (or disposal group) is no longer available for immediate distribution to owners or that the distribution to owners is no longer ‘highly probable’, in accordance with paragraph 12A of IFRS 5.

BC72D The Board observed that IFRIC 17 *Distribution of Non-cash Assets to Owners* amended IFRS 5 by adding paragraphs 5A, 12A and 15A to provide guidance for the held-for-distribution classification. However, this amendment did not provide guidance for when an entity reclassifies an asset (or disposal group) from held for sale to held for distribution to owners (or vice versa), or when held-for-distribution accounting is discontinued. The Board noted that paragraphs 27–29 of IFRS 5 should have been considered for amendment by IFRIC 17 and the fact that they were not amended at the time was an oversight.

BC72E The Board observed that the current guidance in IFRS 5 could be read in a way that a change from a plan to sell a non-current asset (or disposal group) to a plan to distribute a non-current asset (or disposal group) automatically results in a change to a plan of sale and that the guidance in paragraphs 27–29 of IFRS 5 should be applied.

BC72F The Board observed that, consistently with paragraphs 5A of IFRS 5 and BC60 of IFRIC 17, it was the intention of the Board to have consistent criteria and accounting requirements for an asset (or disposal group) classified as held for sale and for an asset (or disposal group) classified as held for distribution to owners. In addition:

- (a) the conditions required by paragraph 8 of IFRS 5 for a sale to be considered highly probable are similar to the conditions required by paragraph 12A of IFRS 5 for a distribution to owners to be considered highly probable, so they should be accounted for in the same way; and
- (b) paragraph 5A of IFRS 5 confirms that the classification, presentation and measurement requirements in IFRS 5 that are applicable for an asset (or disposal group) that is classified as held for sale also apply to an asset (or disposal group) that is classified as held for distribution to owners.

BC72G The Board noted that, on the basis of the current guidance in paragraphs 5A, 8 and 12A of IFRS 5 and the explanations in the Basis for Conclusions on IFRIC 17, the change from being held for sale to held for distribution to owners (or vice versa) when an entity reclassifies an asset (or disposal group) directly from one method of disposal to the other should not be considered a new plan (to sell or distribute). Instead, it should be treated as a continuation of the original plan. This means that an entity moves from one method of disposal to the other without any time lag, so that there is no interruption of the application of the requirements in IFRS 5. This would involve applying the classification, presentation and measurement requirements required for each type of disposal in IFRS 5.

BC72H Consequently, when an entity reclassifies an asset (or disposal group) directly from held for sale to held for distribution to owners (or vice versa), the Board decided to clarify that such a reclassification shall not be treated as a change to a plan of sale (or distribution to owners) and an entity shall not follow the guidance in paragraphs 27–29 of IFRS 5 to account for this change.

BC72I In response to the comments received on the Exposure Draft *Annual Improvements to IFRSs 2012–2014 Cycle* (the ‘2013 Annual Improvements Exposure Draft’), published in December 2013, the Board clarified that at the time of the change in the disposal plan, an entity would need to measure the non-current asset (or disposal group) in accordance with paragraph 15 or 15A of IFRS 5, and recognise any write-down in value (impairment loss) or gain for the subsequent increase in the fair value less costs to sell/costs to distribute a non-current asset (or disposal group) in accordance with paragraphs 20–25 of IFRS 5.

BC72J In response to the comments received on the 2013 Annual Improvements Exposure Draft, the Board further clarified that a change from being held for sale to held for distribution to owners (or vice versa) via a direct reclassification is not a new plan of disposal and does not change the requirements in IFRS 5 to determine whether a sale (or a distribution to owners) is highly probable, in accordance with paragraph 8 (or 12A) of IFRS 5. Consequently, the determination of the 12-month period should not restart when such a change in the method of disposal occurs, but should instead continue to be the same as initially determined by management in its assessment of whether the sale and/or distribution to owners is highly probable. The Board also noted that the period required to complete a sale or distribution to owners can be extended if the conditions in paragraph 9 of IFRS 5 are met. The Board noted that when an entity changes its planned method of disposal via a direct reclassification, it does not restate prior periods to reflect the new method of disposal.

Transitional arrangements

- BC78 Some respondents to ED 4 noted that there could be difficulties in obtaining the information necessary to apply the IFRS retrospectively. The Board agreed that hindsight might be involved in determining at what date assets or disposal groups met the criteria to be classified as held for sale and their fair value at that date. Problems might also arise in separating the results of operations that would have been classified as discontinued operations in prior periods and that had been derecognised in full before the effective date of the IFRS.
- BC79 The Board therefore decided to require application of the IFRS prospectively and allow retrospective application only when the necessary information had been obtained in the prior periods in question.
- BC79A The Board concluded that the effective date of the amendments in paragraphs 8A and 36A for presentation purposes should be 1 July 2009 to be consistent with the effective date of the amendments to IAS 27 (as amended in January 2008) for measurement purposes. Because paragraph 45(c) of IAS 27 provides an exception to retrospective application of the amendments relating to the loss of control of a subsidiary for measurement purposes, the Board required an entity to consider the applicable transitional provisions in IAS 27 when implementing the amendments in paragraphs 8A and 36A.*

Terminology

- BC80 Two issues of terminology arose in developing the IFRS:
- (a) the use of the term ‘probable’ and
 - (b) the use of the term ‘fair value less costs to sell’[#].
- BC81 In SFAS 144, the term *probable* is described as referring to a future sale that is ‘likely to occur’. For the purposes of IFRSs, probable is defined as ‘more likely than not’. To converge on the same meaning as SFAS 144 and to avoid using the term ‘probable’ with different meanings in IFRSs, this IFRS uses the phrase ‘highly probable’. The Board regards ‘highly probable’ as implying a significantly higher probability than ‘more likely than not’ and as implying the same probability as the FASB’s phrase ‘likely to occur’. This is consistent with the Board’s use of ‘highly probable’ in IAS 39.[∇]
- BC82 The measurement basis ‘fair value less costs to sell’ used in SFAS 144 is the same as the measurement ‘net selling price’ used in IAS 36 (as issued in 1998). SFAS 144 defines fair value of an asset as “the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale”, and costs to sell as “the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made.” IAS 36 defines net selling price as the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal. Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expenses.

* The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. Paragraph 45(c) in IAS 27 was moved to paragraph C6(c) of IFRS 10; however, the transition provisions were not changed.

[#] IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

[∇] IFRS 9 *Financial Instruments* replaced by IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

*Guidance on Implementing
Hong Kong Financial Reporting Standard 5*

Non-current Assets Held for Sale and Discontinued Operations



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Example 9

In October 20X5 an entity decides to abandon all of its cotton mills, which constitute a major line of business. All work stops at the cotton mills during the year ended 31 December 20X6. In the financial statements for the year ended 31 December 20X5, results and cash flows of the cotton mills are treated as continuing operations. In the financial statements for the year ended 31 December 20X6, the results and cash flows of the cotton mills are treated as discontinued operations and the entity makes the disclosures required by paragraphs 33 and 34 of the IFRS.

Allocation of an impairment loss on a disposal group

Paragraph 23 of the IFRS requires an impairment loss (or any subsequent gain) recognised for a disposal group to reduce (or increase) the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of the IFRS, in the order of allocation set out in paragraphs 104 and 122 of IAS 36. Example 10 illustrates the allocation of an impairment loss on a disposal group.

Example 10

An entity plans to dispose of a group of its assets (as an asset sale). The assets form a disposal group, and are measured as follows:

	Carrying amount at the end of the reporting period before classification as held for sale	Carrying amount as remeasured immediately before classification as held for sale
	CU*	CU
Goodwill	1,500	1,500
Property, plant and equipment (carried at revalued amounts)	4,600	4,000
Property, plant and equipment (carried at cost)	5,700	5,700
Inventory	2,400	2,200
~~AFS financial assets~~ <u>Investments in equity instruments</u>	1,800	1,500
Total	16,000	14,900

The entity recognises the loss of CU1,100 (CU16,000-CU14,900) immediately before classifying the disposal group as held for sale.

The entity measures the fair value less costs to sell of the disposal group as CU13,000. Because an entity measures a disposal group classified as held for sale at the lower of its carrying amount and fair value less costs to sell, the entity recognises an impairment loss of CU1,900 (CU14,900-CU13,000) when the group is initially classified as held for sale.

The impairment loss is allocated to non-current assets to which the measurement requirements of the IFRS are applicable. Therefore, no impairment loss is allocated to inventory and ~~AFS financial assets~~ investments in equity instruments. The loss is allocated to the other assets in the order of allocation set out in paragraphs 104 and 122 of IAS 36.

* In this guidance, monetary amounts are denominated in 'currency units' (CU).

The allocation can be illustrated as follows:

	Carrying amount as remeasured immediately before classification as held for sale CU	Allocated impairment loss CU	Carrying amount after allocation of impairment loss CU
Goodwill	1,500	(1,500)	0
Property, plant and equipment (carried at revalued amounts)	4,000	(165)	3,835
Property, plant and equipment (carried at cost)	5,700	(235)	5,465
Inventory	2,200	-	2,200
~~AFS financial assets~~	1,500	-	1,500
<u>Investments in equity instruments</u>			
Total	14,900	(1,900)	13,000

First, the impairment loss reduces any amount of goodwill. Then, the residual loss is allocated to other assets pro rata based on the carrying amounts of those assets.

Presenting discontinued operations in the statement of comprehensive income

Paragraph 33 of the IFRS requires an entity to disclose a single amount in the statement of comprehensive income for discontinued operations with an analysis in the notes or in a section of the statement of comprehensive income separate from continuing operations. Example 11 illustrates how these requirements might be met.

Presenting non-current assets or disposal groups classified as held for sale

Paragraph 38 of the IFRS requires an entity to present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held for sale are also presented separately from other liabilities in the statement of financial position. Those assets and liabilities are not offset and presented as a single amount. Example 12 illustrates these requirements.

Example 12

At the end of 20X5, an entity decides to dispose of part of its assets (and directly associated liabilities). The disposal, which meets the criteria in paragraphs 7 and 8 to be classified as held for sale, takes the form of two disposal groups, as follows:

	Carrying amount after classification as held for sale	
	Disposal group I: CU	Disposal group II: CU
Property, plant and equipment	4,900	1,700
~~AFS financial asset~~ <u>Investments in equity instruments</u>	1,400*	-
Liabilities	(2,400)	(900)
Net carrying amount of disposal group	3,900	800

* An amount of CU400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.

HKFRS 7
Revised December 2016 September 2018

Effective for annual periods
beginning on or after 1 January 2007

Hong Kong Financial Reporting Standard 7

Financial Instruments: Disclosures



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 7 *Financial Instruments: Disclosures* (HKFRS 7) is set out in paragraphs 1-45 and Appendices A-~~DC~~. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 7 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

- IN1 In recent years, the techniques used by entities for measuring and managing exposure to risks arising from financial instruments have evolved and new risk management concepts and approaches have gained acceptance. In addition, many public and private sector initiatives have proposed improvements to the disclosure framework for risks arising from financial instruments.
- IN2 The Hong Kong Institute of Certified Public Accountants (Institute) believes that users of financial statements need information about an entity's exposure to risks and how those risks are managed. Such information can influence a user's assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows. Greater transparency regarding those risks allows users to make more informed judgements about risk and return.
- IN3 Consequently, the Institute agreed that there was a need to revise and enhance the disclosures in HKAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and HKAS 32 *Financial Instruments: Disclosure and Presentation*. As part of this revision, the Institute removed duplicative disclosures and simplified the disclosures about concentrations of risk, credit risk, liquidity risk and market risk in HKAS 32.

Main features of the HKFRS

- IN4 HKFRS 7 applies to all risks arising from all financial instruments, except those instruments listed in paragraph 3. The HKFRS applies to all entities, including entities that have few financial instruments (eg a manufacturer whose only financial instruments are accounts receivable and accounts payable) and those that have many financial instruments (eg a financial institution most of whose assets and liabilities are financial instruments). However, the extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.
- IN5 The HKFRS requires disclosure of:
- (a) the significance of financial instruments for an entity's financial position and performance. These disclosures incorporate many of the requirements previously in HKAS 32.
 - (b) qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.
- IN5A Amendments to the HKFRS, issued in March 2009, require enhanced disclosures about fair value measurements and liquidity risk. These have been made to address application issues and provide useful information to users.
- IN5B *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7), issued in October 2010, amended the required disclosures to help users of financial statements evaluate the risk exposures relating to transfers of financial assets and the effect of those risks on an entity's financial position.

- IN5C In June 2011 the HKICPA relocated the disclosures about fair value measurements to HKFRS 13 *Fair Value Measurement*.
- IN6 The HKFRS includes in Appendix B mandatory application guidance that explains how to apply the requirements in the HKFRS. The HKFRS is accompanied by non-mandatory Implementation Guidance that describes how an entity might provide the disclosures required by the HKFRS.
- IN7 The HKFRS supersedes HKAS 30 and the disclosure requirements of HKAS 32. The presentation requirements of HKAS 32 remain unchanged.
- IN8 The HKFRS is effective for annual periods beginning on or after 1 January 2007. Earlier application is encouraged.
- IN9 *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to HKFRS 7), issued in December 2011, amended the required disclosures to include information that will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities, on the entity's financial position.

Hong Kong Financial Reporting Standard 7

Financial Instruments: Disclosures

Objective

- 1 The objective of this HKFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:
 - (a) the significance of financial instruments for the entity's financial position and performance; and
 - (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
- 2 The principles in this HKFRS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in HKAS 32 *Financial Instruments: Presentation* and ~~HKAS 39~~ HKFRS 9 *Financial Instruments: Recognition and Measurement*.

Scope

- 3 This HKFRS shall be applied by all entities to all types of financial instruments, except:
 - (a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with HKFRS 10 *Consolidated Financial Statements*, HKAS 27 *Separate Financial Statements* or HKAS 28 *Investments in Associates and Joint Ventures*. However, in some cases, HKFRS 10, HKAS 27 or HKAS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture using ~~HKAS 39~~ HKFRS 9; in those cases, entities shall apply the requirements of this HKFRS and, for those measured at fair value, the requirements of HKFRS 13 *Fair Value Measurement*. Entities shall also apply this HKFRS to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in HKAS 32.
 - (b) employers' rights and obligations arising from employee benefit plans, to which HKAS 19 *Employee Benefits* applies.
 - (c) [deleted]
 - (d) insurance contracts as defined in HKFRS 4 *Insurance Contracts*. However, this HKFRS applies to derivatives that are embedded in insurance contracts if ~~HKAS 39~~ HKFRS 9 requires the entity to account for them separately. Moreover, an issuer shall apply this HKFRS to *financial guarantee contracts* if the issuer applies ~~HKAS 39~~ HKFRS 9 in recognising and measuring the contracts, but shall apply HKFRS 4 if the issuer elects, in accordance with paragraph 4(d) of HKFRS 4, to apply HKFRS 4 in recognising and measuring them.
 - (e) financial instruments, contracts and obligations under share-based payment transactions to which HKFRS 2 *Share-based Payment* applies, except that this HKFRS applies to contracts within the scope of ~~paragraphs 5-7 of HKAS 39~~ HKFRS 9.
 - (f) instruments that are required to be classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32.

- 4 This HKFRS applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of ~~HKAS 39~~HKFRS 9. Unrecognised financial instruments include some financial instruments that, although outside the scope of ~~HKAS 39~~ HKFRS 9, are within the scope of this HKFRS ~~(such as some loan commitments)~~.
- 5 This HKFRS applies to contracts to buy or sell a non-financial item that are within the scope of ~~HKAS 39 (see paragraphs 5-7 of HKAS 39)~~HKFRS 9.
- 5A The credit risk disclosure requirements in paragraph 35A-35N apply to those rights that HKFRS 15 *Revenue from Contracts with Customers* specifies are accounted for in accordance with HKFRS 9 for the purposes of recognising impairment gains or losses. Any reference to financial assets or financial instruments in these paragraphs shall include those rights unless otherwise specified.

Classes of financial instruments and level of disclosure

- 6 When this HKFRS requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Significance of financial instruments for financial position and performance

- 7 **An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.**

Statement of financial position

Categories of financial assets and financial liabilities

- 8 The carrying amounts of each of the following categories, as ~~defined in HKAS 39~~specified in HKFRS 9, shall be disclosed either in the statement of financial position or in the notes:
- (a) financial assets measured at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of HKFRS 9 and (ii) those ~~classified as held for trading in accordance with HKAS 39; mandatorily measured at fair value through profit or loss in accordance with HKFRS 9.~~
 - (b)-(d) ~~held-to-maturity investments; [deleted]~~
 - (e) ~~loans and receivables;—~~
 - (d) ~~available-for-sale financial assets;~~
 - (e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of HKFRS 9 and (ii) those classified as that meet the definition of held for trading in accordance with HKAS 39; and HKFRS 9.
 - (f) ~~financial liabilities—assets~~ measured at amortised cost.
 - (g) financial liabilities measured at amortised cost.

- (h) financial assets measured at fair value through other comprehensive income, showing separately (i) financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9; and (ii) investments in equity instruments designated as such upon initial recognition in accordance with paragraph 5.7.5 of HKFRS 9.

Financial assets or financial liabilities at fair value through profit or loss

- 9 If the entity has designated a loan or receivable as measured at fair value through profit or loss a financial asset (or group of loans or receivables financial assets) as at fair value through profit or loss that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

- (a) the maximum exposure to *credit risk* (see paragraph 36(a)) of the ~~loan or receivable~~ financial asset (or group of ~~loans or receivables~~ financial assets) at the end of the reporting period.
- (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk (see paragraph 36(b)).
- (c) the amount of change, during the period and cumulatively, in the fair value of the ~~loan or receivable~~ financial asset (or group of ~~loans or receivables~~ financial assets) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to *market risk*; or
 - (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

- (d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the ~~loan or receivable~~ financial asset was designated.
- 10 If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 9 of HKAS 39 4.2.2 of HKFRS 9 and is required to present the effects of changes in that liability's credit risk in other comprehensive income (see paragraph 5.7.7 of HKFRS 9), it shall disclose:

- (a) the amount of change, ~~during the period and~~ cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability ~~determined either (see paragraphs B5.7.13-B5.7.20 of HKFRS 9 for guidance on determining the effects of changes in a liability's credit risk).~~
 - (i) ~~as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see Appendix B, paragraph B4); or~~
 - (ii) ~~using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.~~
- (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

- (c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
 - (d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.
- 10A** If an entity has designed a financial liability as at fair value through profit or loss in accordance with paragraph 4.2.2 of HKFRS 9 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss (see paragraphs 5.7.7 and 5.7.8 of HKFRS 9), it shall disclose:
- (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs B5.7.13-B5.7.20 of HKFRS 9 for guidance on determining the effects of changes in a liability's credit risk); and
 - (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- 11** The entity shall also disclose:
- (a) a detailed description of the methods used to comply with the requirements in paragraphs 9(c) and 10(a) and 10A(a) and paragraph 5.7.7(a) of HKFRS 9, including an explanation of why the method is appropriate.
 - (b) if the entity believes that the disclosure it has given, either in the statement of financial position or in the notes, to comply with the requirements in paragraph 9(c) or 10(a) or 10A(a) or paragraph 5.7.7(a) of HKFRS 9 does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.
 - (c) a detailed description of the methodology or methodologies used to determine whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss (see paragraphs 5.7.7 and 5.7.8 of HKFRS 9). If an entity is required to present the effects of changes in a liability's credit risk in profit or loss (see paragraphs 5.7.8 of HKFRS 9), the disclosure must include a detailed description of the economic relationship described in paragraph B5.7.6 of HKFRS 9.

Investments in equity instruments designated at fair value through other comprehensive income

- 11A** If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 5.7.5 of HKFRS 9, it shall disclose:
- (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.
 - (b) the reasons for using this presentation alternative.
 - (c) the fair value of each such investment at the end of the reporting period.
 - (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.
 - (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

11B If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:

- (a) the reasons for disposing of the investments.
- (b) the fair value of the investments at the date of derecognition.
- (c) the cumulative gain or loss on disposal.

Reclassification

~~12-12A [Deleted] If the entity has reclassified a financial asset (in accordance with paragraphs 51-54 of HKAS 39) as one measured:~~

- ~~(a) at cost or amortised cost, rather than fair value; or~~
- ~~(b) at fair value, rather than at cost or amortised cost;~~

~~it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.~~

~~12A If the entity has reclassified a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B or 50D of HKAS 39 or out of the available-for-sale category in accordance with paragraph 50E of HKAS 39, it shall disclose:~~

- ~~(a) the amount reclassified into and out of each category;~~
- ~~(b) for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;~~
- ~~(c) if a financial asset was reclassified in accordance with paragraph 50B, the rare situation, and the facts and circumstances indicating that the situation was rare;~~
- ~~(d) for the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income in that reporting period and in the previous reporting period;~~
- ~~(e) for each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income if the financial asset had not been reclassified, and the gain, loss, income and expense recognised in profit or loss; and~~
- ~~(f) the effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.~~

12B An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 4.4.1 of HKFRS 9. For each such event, an entity shall disclose:

- (a) the date of reclassification.
- (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

(c) the amount reclassified into and out of each category.

12C For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income in accordance with paragraph 4.4.1 of HKFRS 9:

(a) the effective interest rate determined on the date of reclassification; and

(b) the interest revenue recognised.

12D If, since its last annual reporting date, an entity has reclassified financial assets out of the fair value through other comprehensive income category so that they are measured at amortised cost or out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income it shall disclose:

(a) the fair value of the financial assets at the end of the reporting period; and

(b) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets had not been reclassified.

13 [Deleted]

Offsetting financial assets and financial liabilities

13A The disclosures in paragraphs 13B–13E supplement the other disclosure requirements of this HKFRS and are required for all recognised financial instruments that are set off in accordance with paragraph 42 of HKAS 32. These disclosures also apply to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are set off in accordance with paragraph 42 of HKAS 32.

13B An entity shall disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position. This includes the effect or potential effect of rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities that are within the scope of paragraph 13A.

13C To meet the objective in paragraph 13B, an entity shall disclose, at the end of the reporting period, the following quantitative information separately for recognised financial assets and recognised financial liabilities that are within the scope of paragraph 13A:

(a) the gross amounts of those recognised financial assets and recognised financial liabilities;

(b) the amounts that are set off in accordance with the criteria in paragraph 42 of HKAS 32 when determining the net amounts presented in the statement of financial position;

(c) the net amounts presented in the statement of financial position;

(d) the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 13C(b), including:

(i) amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of HKAS 32; and

- (ii) amounts related to financial collateral (including cash collateral); and
- (e) the net amount after deducting the amounts in (d) from the amounts in (c) above.

The information required by this paragraph shall be presented in a tabular format, separately for financial assets and financial liabilities, unless another format is more appropriate.

- 13D The total amount disclosed in accordance with paragraph 13C(d) for an instrument shall be limited to the amount in paragraph 13C(c) for that instrument.
- 13E An entity shall include a description in the disclosures of the rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities subject to enforceable master netting arrangements and similar agreements that are disclosed in accordance with paragraph 13C(d), including the nature of those rights.
- 13F If the information required by paragraphs 13B–13E is disclosed in more than one note to the financial statements, an entity shall cross-refer between those notes.

Collateral

- 14 An entity shall disclose:
 - (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph ~~37(a) of HKAS 39~~ 3.2.23(a) of HKFRS 9; and
 - (b) the terms and conditions relating to its pledge.
- 15 When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:
 - (a) the fair value of the collateral held;
 - (b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
 - (c) the terms and conditions associated with its use of the collateral.

Allowance account for credit losses

- 16 ~~When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.~~ ~~[Deleted]~~
- 16A The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

Compound financial instruments with multiple embedded derivatives

- 17 If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 28 of HKAS 32) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

Defaults and breaches

- 18 For *loans payable* recognised at the end of the reporting period, an entity shall disclose:
- (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
 - (b) the carrying amount of the loans payable in default at the end of the reporting period; and
 - (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.
- 19 If, during the period, there were breaches of loan agreement terms other than those described in paragraph 18, an entity shall disclose the same information as required by paragraph 18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).

Statement of comprehensive income

Items of income, expense, gains or losses

- 20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:
- (a) net gains or net losses on:
 - (i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of HKFRS 9, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with HKFRS 9 (eg financial liabilities that meet the definition of classified as held for trading in accordance with HKAS 39; HKFRS 9). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.
 - ~~(ii)-(iv) [deleted] available for sale financial assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified from equity to profit or loss for the period;~~
 - ~~(iii) held-to-maturity investments;~~
 - ~~(iv) loans and receivables; and~~
 - (v) financial liabilities measured at amortised cost;
 - ~~(vi) financial assets measured at amortised cost.~~
 - ~~(vii) investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of~~

HKFRS 9.

- (viii) financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.
- (b) total interest ~~income-revenue~~ and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss;
- (c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
- (i) financial assets ~~or~~ and financial liabilities that are not at fair value through profit or loss; and
- (ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
- (d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of HKAS 39; and~~[deleted]~~
- (e) the amount of any impairment loss for each class of financial asset.~~[deleted]~~
- 20A An entity shall disclose an analysis of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure shall include the reasons for derecognising those financial assets.

Other disclosures

Accounting policies

- 21 In accordance with paragraph 117 of HKAS 1 *Presentation of Financial Statements* (as revised 2007), an entity discloses its significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge accounting

- 21A An entity shall apply the disclosure requirements in paragraphs 21B–24F for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:
- (a) an entity's risk management strategy and how it is applied to manage risk;
- (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- (c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in

equity.

- 21B An entity shall present the required disclosures in a single note or separate section in its financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.
- 21C When paragraphs 22A–24F require the entity to separate by risk category the information disclosed, the entity shall determine each risk category on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. An entity shall determine risk categories consistently for all hedge accounting disclosures.
- 21D To meet the objectives in paragraph 21A, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the quantitative information disclosed. However, an entity shall use the same level of aggregation or disaggregation it uses for disclosure requirements of related information in this HKFRS and HKFRS 13 *Fair Value Measurement*.

The risk management strategy

- 22 ~~[Deleted]~~An entity shall disclose the following separately for each type of hedge described in HKAS 39 (ie fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):
- ~~(a) — a description of each type of hedge;~~
 - ~~(b) — a description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and~~
 - ~~(c) — the nature of the risks being hedged.~~
- 22A An entity shall explain its risk management strategy for each risk category of risk exposures that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate (for example):
- (a) how each risk arises.
 - (b) how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item and why.
 - (c) the extent of risk exposures that the entity manages.
- 22B To meet the requirements in paragraph 22A, the information should include (but is not limited to) a description of:
- (a) the hedging instruments that are used (and how they are used) to hedge risk exposures;
 - (b) how the entity determines the economic relationship between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness; and

- (c) how the entity establishes the hedge ratio and what the sources of hedge ineffectiveness are.

22C When an entity designates a specific risk component as a hedged item (see paragraph 6.3.7 of HKFRS 9) it shall provide, in addition to the disclosures required by paragraphs 22A and 22B, qualitative or quantitative information about:

- (a) how the entity determined the risk component that is designated as the hedged item (including a description of the nature of the relationship between the risk component and the item as a whole); and
- (b) how the risk component relates to the item in its entirety (for example, the designated risk component historically covered on average 80 per cent of the changes in fair value of the item as a whole).

The amount, timing and uncertainty of future cash flows

23 ~~[Deleted]~~For cash flow hedges, an entity shall disclose:

- (a) ~~the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;—~~
- (b) ~~a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;—~~
- (c) ~~the amount that was recognised in other comprehensive income during the period;~~
- (d) ~~the amount that was reclassified from equity to profit or loss for the period, showing the amount included in each line item in the statement of comprehensive income; and~~
- (e) ~~the amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.—~~

23A Unless exempted by paragraph 23C, an entity shall disclose by risk category quantitative information to allow users of its financial statements to evaluate the terms and conditions of hedging instruments and how they affect the amount, timing and uncertainty of future cash flows of the entity.

23B To meet the requirement in paragraph 23A, an entity shall provide a breakdown that discloses:

- (a) a profile of the timing of the nominal amount of the hedging instrument; and
- (b) if applicable, the average price or rate (for example strike or forward prices etc) of the hedging instrument.

23C In situations in which an entity frequently resets (ie discontinues and restarts) hedging relationships because both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the exposure and the hedging instruments used to manage that exposure do not remain the same for long—such as in the example in paragraph B6.5.24(b) of HKFRS 9) the entity:

- (a) is exempt from providing the disclosures required by paragraphs 23A and 23B.
- (b) shall disclose:

- (i) information about what the ultimate risk management strategy is in relation to those hedging relationships;
- (ii) a description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
- (iii) an indication of how frequently the hedging relationships are discontinued and restarted as part of the entity's process in relation to those hedging relationships.

23D An entity shall disclose by risk category a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.

23E If other sources of hedge ineffectiveness emerge in a hedging relationship, an entity shall disclose those sources by risk category and explain the resulting hedge ineffectiveness.

23F For cash flow hedges, an entity shall disclose a description of any forecast transaction for which hedge accounting had been used in the previous period, but which is no longer expected to occur.

The effects of hedge accounting on financial position and performance

24 ~~[Deleted]~~An entity shall disclose separately:

- ~~(a) — in fair value hedges, gains or losses:—~~
 - ~~(i) — on the hedging instrument; and—~~
 - ~~(ii) — on the hedged item attributable to the hedged risk.~~
- ~~(b) — the ineffectiveness recognised in profit or loss that arises from cash flow hedges.~~
- ~~(c) — the ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations.~~

24A An entity shall disclose, in a tabular format, the following amounts related to items designated as hedging instruments separately by risk category for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):

- (a) the carrying amount of the hedging instruments (financial assets separately from financial liabilities);
- (b) the line item in the statement of financial position that includes the hedging instrument;
- (c) the change in fair value of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period; and
- (d) the nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.

24B An entity shall disclose, in a tabular format, the following amounts related to hedged items separately by risk category for the types of hedges as follows:

- (a) for fair value hedges:

- (i) the carrying amount of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);
 - (ii) the accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);
 - (iii) the line item in the statement of financial position that includes the hedged item;
 - (iv) the change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period; and
 - (v) the accumulated amount of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses in accordance with paragraph 6.5.10 of HKFRS 9.
- (b) for cash flow hedges and hedges of a net investment in a foreign operation:
- (i) the change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period (ie for cash flow hedges the change in value used to determine the recognised hedge ineffectiveness in accordance with paragraph 6.5.11(c) of HKFRS 9);
 - (ii) the balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges that are accounted for in accordance with paragraphs 6.5.11 and 6.5.13(a) of HKFRS 9; and
 - (iii) the balances remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting is no longer applied.

24C An entity shall disclose, in a tabular format, the following amounts separately by risk category for the types of hedges as follows:

- (a) for fair value hedges:
- (i) hedge ineffectiveness—ie the difference between the hedging gains or losses of the hedging instrument and the hedged item—recognised in profit or loss (or other comprehensive income for hedges of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9); and
 - (ii) the line item in the statement of comprehensive income that includes the recognised hedge ineffectiveness.
- (b) for cash flow hedges and hedges of a net investment in a foreign operation:
- (i) hedging gains or losses of the reporting period that were recognised in other comprehensive income;
 - (ii) hedge ineffectiveness recognised in profit or loss;
 - (iii) the line item in the statement of comprehensive income that includes the recognised hedge ineffectiveness;
 - (iv) the amount reclassified from the cash flow hedge reserve or the

foreign currency translation reserve into profit or loss as a reclassification adjustment (see HKAS 1) (differentiating between amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss);

(v) the line item in the statement of comprehensive income that includes the reclassification adjustment (see HKAS 1); and

(vi) for hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive income (see paragraph 6.6.4 of HKFRS 9).

24D When the volume of hedging relationships to which the exemption in paragraph 23C applies is unrepresentative of normal volumes during the period (ie the volume at the reporting date does not reflect the volumes during the period) an entity shall disclose that fact and the reason it believes the volumes are unrepresentative.

24E An entity shall provide a reconciliation of each component of equity and an analysis of other comprehensive income in accordance with HKAS 1 that, taken together:

(a) differentiates, at a minimum, between the amounts that relate to the disclosures in paragraph 24C(b)(i) and (b)(iv) as well as the amounts accounted for in accordance with paragraph 6.5.11(d)(i) and (d)(iii) of HKFRS 9;

(b) differentiates between the amounts associated with the time value of options that hedge transaction related hedged items and the amounts associated with the time value of options that hedge time-period related hedged items when an entity accounts for the time value of an option in accordance with paragraph 6.5.15 of HKFRS 9; and

(c) differentiates between the amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge transaction related hedged items, and the amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge time-period related hedged items when an entity accounts for those amounts in accordance with paragraph 6.5.16 of HKFRS 9.

24F An entity shall disclose the information required in paragraph 24E separately by risk category. This disaggregation by risk may be provided in the notes to the financial statements.

Option to designate a credit exposure as measured at fair value through profit or Loss

24G If an entity designated a financial instrument, or a proportion of it, as measured at fair value through profit or loss because it uses a credit derivative to manage the credit risk of that financial instrument it shall disclose:

(a) for credit derivatives that have been used to manage the credit risk of financial instruments designated as measured at fair value through profit or loss in accordance with paragraph 6.7.1 of HKFRS 9, a reconciliation of each of the nominal amount and the fair value at the beginning and at the end of the period;

(b) the gain or loss recognised in profit or loss on designation of a financial instrument, or a proportion of it, as measured at fair value through profit or loss in accordance with paragraph 6.7.1 of HKFRS 9; and

- (c) on discontinuation of measuring a financial instrument, or a proportion of it, at fair value through profit or loss, that financial instrument's fair value that has become the new carrying amount in accordance with paragraph 6.7.4 of HKFRS 9 and the related nominal or principal amount (except for providing comparative information in accordance with HKAS 1, an entity does not need to continue this disclosure in subsequent periods).

Fair value

- 25 Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.
- 26 In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.
- 27-27B [Deleted]
- 28 In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets (see paragraph ~~AG76 of HKAS 39~~B5.1.2A of HKFRS 9). In such cases, the entity shall disclose by class of financial asset or financial liability:
- (a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability (see paragraph ~~AG76(b) of HKAS 39~~B5.1.2A(b) of HKFRS 9).
 - (b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.
 - (c) why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.
- 29 Disclosures of fair value are not required:
- (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
 - (b) ~~for an investment in equity instruments that do not have a quoted market price in an active market for an identical instrument (ie a Level 1 input), or derivatives linked to such equity instruments, that is measured at cost in accordance with HKAS 39 because its fair value cannot otherwise be measured reliably; or~~[deleted]
 - (c) for a contract containing a discretionary participation feature (as described in HKFRS 4) if the fair value of that feature cannot be measured reliably.
- 30 In the cases described in paragraph 29~~(b) and~~(c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those ~~financial assets or financial liabilities~~contracts and their fair value, including:

- (a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
- (b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
- (c) information about the market for the instruments;
- (d) information about whether and how the entity intends to dispose of the financial instruments; and
- (e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

Nature and extent of risks arising from financial instruments

- 31 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.**
- 32 The disclosures required by paragraphs 33-42 focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, *liquidity risk* and market risk.
- 32A Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The interaction between qualitative and quantitative disclosures contributes to disclosure of information in a way that better enables users to evaluate an entity's exposure to risks.

Qualitative disclosures

- 33 For each type of risk arising from financial instruments, an entity shall disclose:
- (a) the exposures to risk and how they arise;
 - (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
 - (c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

- 34 For each type of risk arising from financial instruments, an entity shall disclose:
- (a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
 - (b) the disclosures required by paragraphs ~~36~~35A-42, to the extent not provided in accordance with (a).
 - (c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

- 35 If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

Credit risk

Scope and objectives

35A An entity shall apply the disclosure requirements in paragraphs 35F–35N to financial instruments to which the impairment requirements in HKFRS 9 are applied. However:

- (a) for trade receivables, contract assets and lease receivables, paragraph 35J(a) applies to those trade receivables, contract assets or lease receivables on which lifetime expected credit losses are recognised in accordance with paragraph 5.5.15 of HKFRS 9, if those financial assets are modified while more than 30 days past due; and
- (b) paragraph 35K(b) does not apply to lease receivables.

35B The credit risk disclosures made in accordance with paragraphs 35F–35N shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide:

- (a) information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses;
- (b) quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; and
- (c) information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

35C An entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to other statements, such as a management commentary or risk report that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

35D To meet the objectives in paragraph 35B, an entity shall (except as otherwise specified) consider how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

35E If the disclosures provided in accordance with paragraphs 35F–35N are insufficient to meet the objectives in paragraph 35B, an entity shall disclose additional information that is necessary to meet those objectives.

The credit risk management practices

35F An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an entity shall disclose information that enables users of financial statements to understand and evaluate:

- (a) how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:
 - (i) financial instruments are considered to have low credit risk in accordance with paragraph 5.5.10 of HKFRS 9, including the classes of financial instruments to which it applies; and
 - (ii) the presumption in paragraph 5.5.11 of HKFRS 9, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted;
- (b) an entity's definitions of default, including the reasons for selecting those definitions;
- (c) how the instruments were grouped if expected credit losses were measured on a collective basis;
- (d) how an entity determined that financial assets are credit-impaired financial assets;
- (e) an entity's write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity; and
- (f) how the requirements in paragraph 5.5.12 of HKFRS 9 for the modification of contractual cash flows of financial assets have been applied, including how an entity:
 - (i) determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses in accordance with paragraph 5.5.5 of HKFRS 9; and
 - (ii) monitors the extent to which the loss allowance on financial assets meeting the criteria in (i) is subsequently remeasured at an amount equal to lifetime expected credit losses in accordance with paragraph 5.5.3 of HKFRS 9.

35G An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in Section 5.5 of HKFRS 9. For this purpose an entity shall disclose:

- (a) the basis of inputs and assumptions and the estimation techniques used to:
 - (i) measure the 12-month and lifetime expected credit losses;
 - (ii) determine whether the credit risk of financial instruments has increased significantly since initial recognition; and
 - (iii) determine whether a financial asset is a credit-impaired financial asset.
- (b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and
- (c) changes in the estimation techniques or significant assumptions made during

the reporting period and the reasons for those changes.

Quantitative and qualitative information about amounts arising from expected credit losses

35H To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:

- (a) the loss allowance measured at an amount equal to 12-month expected credit losses;
- (b) the loss allowance measured at an amount equal to lifetime expected credit losses for:
 - (i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
 - (ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
 - (iii) trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with paragraph 5.5.15 of HKFRS 9.
- (c) financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

35I To enable users of financial statements to understand the changes in the loss allowance disclosed in accordance with paragraph 35H, an entity shall provide an explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. The information shall be provided separately for financial instruments that represent the loss allowance as listed in paragraph 35H(a)–(c) and shall include relevant qualitative and quantitative information. Examples of changes in the gross carrying amount of financial instruments that contributed to the changes in the loss allowance may include:

- (a) changes because of financial instruments originated or acquired during the reporting period;
- (b) the modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets in accordance with HKFRS 9;
- (c) changes because of financial instruments that were derecognised (including those that were written-off) during the reporting period; and
- (d) changes arising from whether the loss allowance is measured at an amount equal to 12-month or lifetime expected credit losses.

35J To enable users of financial statements to understand the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition and the effect of such modifications on the measurement of expected credit losses, an entity shall disclose:

- (a) the amortised cost before the modification and the net modification gain or

loss recognised for financial assets for which the contractual cash flows have been modified during the reporting period while they had a loss allowance measured at an amount equal to lifetime expected credit losses; and

- (b) the gross carrying amount at the end of the reporting period of financial assets that have been modified since initial recognition at a time when the loss allowance was measured at an amount equal to lifetime expected credit losses and for which the loss allowance has changed during the reporting period to an amount equal to 12-month expected credit losses.

35K To enable users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses, an entity shall disclose by class of financial instrument:

- (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with HKAS 32).
- (b) a narrative description of collateral held as security and other credit enhancements, including:
 - (i) a description of the nature and quality of the collateral held;
 - (ii) an explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the collateral policies of the entity during the reporting period; and
 - (iii) information about financial instruments for which an entity has not recognised a loss allowance because of the collateral.
- (c) quantitative information about the collateral held as security and other credit enhancements (for example, quantification of the extent to which collateral and other credit enhancements mitigate credit risk) for financial assets that are credit-impaired at the reporting date.

35L An entity shall disclose the contractual amount outstanding on financial assets that were written off during the reporting period and are still subject to enforcement activity.

Credit risk exposure

35M To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by *credit risk rating grades*, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

- (a) for which the loss allowance is measured at an amount equal to 12-month expected credit losses;
- (b) for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:
 - (i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
 - (ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
 - (iii) trade receivables, contract assets or lease receivables for which the

loss allowances are measured in accordance with paragraph 5.5.15 of HKFRS 9.

(c) that are purchased or originated credit-impaired financial assets.

35N For trade receivables, contract assets and lease receivables to which an entity applies paragraph 5.5.15 of HKFRS 9, the information provided in accordance with paragraph 35M may be based on a provision matrix (see paragraph B5.5.35 of HKFRS 9).

36 For all financial instruments within the scope of this HKFRS, but to which the impairment requirements in HKFRS 9 are not applied, An entity shall disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with HKAS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.

(b) a description of collateral held as security and ~~of~~ other credit enhancements, and their financial effect (eg a quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).

(c) ~~information about the credit quality of financial assets that are neither past due nor impaired.~~[deleted]

(d) ~~[deleted]~~

~~Financial assets that are either past due or impaired~~

37 ~~[Deleted]~~An entity shall disclose by class of financial asset:

~~(a) an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and~~

~~(b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.~~

~~(c) [deleted]~~

Collateral and other credit enhancements obtained

38 When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other HKFRSs, an entity shall disclose for such assets held at the reporting date:

(a) the nature and carrying amount of the assets; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity risk

39 An entity shall disclose:

- (a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.
- (b) a maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows (see paragraph B11B).
- (c) a description of how it manages the liquidity risk inherent in (a) and (b).

Market risk

Sensitivity analysis

40 Unless an entity complies with paragraph 41, it shall disclose:

- (a) a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
- (b) the methods and assumptions used in preparing the sensitivity analysis; and
- (c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

41 If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:

- (a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
- (b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other market risk disclosures

42 When the sensitivity analyses disclosed in accordance with paragraph 40 or 41 are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Transfers of financial assets

42A The disclosure requirements in paragraphs 42B–42H relating to transfers of financial assets supplement the other disclosure requirements of this IFRS. An entity shall present the disclosures required by paragraphs 42B–42H in a single note in its financial statements. An entity shall provide the required disclosures for all transferred financial assets that are not derecognised and for any continuing involvement in a transferred asset, existing at the reporting date, irrespective of when the related transfer transaction occurred. For the purposes of applying the

disclosure requirements in those paragraphs, an entity transfers all or a part of a financial asset (the transferred financial asset) if, and only if, it either:

- (a) transfers the contractual rights to receive the cash flows of that financial asset; or
- (b) retains the contractual rights to receive the cash flows of that financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement.

42B An entity shall disclose information that enables users of its financial statements:

- (a) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
- (b) to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

42C For the purposes of applying the disclosure requirements in paragraphs 42E–42H, an entity has continuing involvement in a transferred financial asset if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to the transferred financial asset. For the purposes of applying the disclosure requirements in paragraphs 42E–42H, the following do not constitute continuing involvement:

- (a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;
- (b) forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset; or
- (c) an arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities and the conditions in paragraph 19(a)–(c) of HKAS 393.2.5(a)–(c) of HKFRS 9 are met.

Transferred financial assets that are not derecognised in their entirety

42D An entity may have transferred financial assets in such a way that part or all of the transferred financial assets do not qualify for derecognition. To meet the objectives set out in paragraph 42B(a), the entity shall disclose at each reporting date for each class of transferred financial assets that are not derecognised in their entirety:

- (a) the nature of the transferred assets.
- (b) the nature of the risks and rewards of ownership to which the entity is exposed.
- (c) a description of the nature of the relationship between the transferred assets and the associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets.
- (d) when the counterparty (counterparties) to the associated liabilities has (have) recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net

position (the difference between the fair value of the transferred assets and the associated liabilities).

- (e) when the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities.
- (f) when the entity continues to recognise the assets to the extent of its continuing involvement (see paragraphs 20(c)(ii) and 30 of HKAS 39 paragraphs 3.2.6(c)(ii) and 3.2.16 of HKFRS 9), the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Transferred financial assets that are derecognised in their entirety

42E To meet the objectives set out in paragraph 42B(b), when an entity derecognises transferred financial assets in their entirety (see paragraph 20(a) and (c)(i) of HKAS 39 3.2.6(a) and (c)(i) of HKFRS 9) but has continuing involvement in them, the entity shall disclose, as a minimum, for each type of continuing involvement at each reporting date:

- (a) the carrying amount of the assets and liabilities that are recognised in the entity's statement of financial position and represent the entity's continuing involvement in the derecognised financial assets, and the line items in which the carrying amount of those assets and liabilities are recognised.
- (b) the fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets.
- (c) the amount that best represents the entity's maximum exposure to loss from its continuing involvement in the derecognised financial assets, and information showing how the maximum exposure to loss is determined.
- (d) the undiscounted cash outflows that would or may be required to repurchase derecognised financial assets (eg the strike price in an option agreement) or other amounts payable to the transferee in respect of the transferred assets. If the cash outflow is variable then the amount disclosed should be based on the conditions that exist at each reporting date.
- (e) a maturity analysis of the undiscounted cash outflows that would or may be required to repurchase the derecognised financial assets or other amounts payable to the transferee in respect of the transferred assets, showing the remaining contractual maturities of the entity's continuing involvement.
- (f) qualitative information that explains and supports the quantitative disclosures required in (a)–(e).

42F An entity may aggregate the information required by paragraph 42E in respect of a particular asset if the entity has more than one type of continuing involvement in that derecognised financial asset, and report it under one type of continuing involvement.

42G In addition, an entity shall disclose for each type of continuing involvement:

- (a) the gain or loss recognised at the date of transfer of the assets.
- (b) income and expenses recognised, both in the reporting period and cumulatively, from the entity's continuing involvement in the derecognised financial assets (eg fair value changes in derivative instruments).

- (c) if the total amount of proceeds from transfer activity (that qualifies for derecognition) in a reporting period is not evenly distributed throughout the reporting period (eg if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period):
 - (i) when the greatest transfer activity took place within that reporting period (eg the last five days before the end of the reporting period),
 - (ii) the amount (eg related gains or losses) recognised from transfer activity in that part of the reporting period, and
 - (iii) the total amount of proceeds from transfer activity in that part of the reporting period.

An entity shall provide this information for each period for which a statement of comprehensive income is presented.

Supplementary information

- 42H An entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph 42B.

Initial application of HKFRS 9

- 42I In the reporting period that includes the date of initial application of HKFRS 9, the entity shall disclose the following information for each class of financial assets and financial liabilities as at the date of initial application:

- (a) the original measurement category and carrying amount determined in accordance with HKAS 39 or in accordance with a previous version of HKFRS 9 (if the entity's chosen approach to applying HKFRS 9 involves more than one date of initial application for different requirements);
- (b) the new measurement category and carrying amount determined in accordance with HKFRS 9;
- (c) the amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated, distinguishing between those that HKFRS 9 requires an entity to reclassify and those that an entity elects to reclassify at the date of initial application.

In accordance with paragraph 7.2.2 of HKFRS 9, depending on the entity's chosen approach to applying HKFRS 9, the transition can involve more than one date of initial application. Therefore this paragraph may result in disclosure on more than one date of initial application. An entity shall present these quantitative disclosures in a table unless another format is more appropriate.

- 42J In the reporting period that includes the date of initial application of HKFRS 9, an entity shall disclose qualitative information to enable users to understand:

- (a) how it applied the classification requirements in HKFRS 9 to those financial assets whose classification has changed as a result of applying HKFRS 9.
- (b) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss at the date of initial application.

In accordance with paragraph 7.2.2 of HKFRS 9, depending on the entity's chosen approach to applying HKFRS 9, the transition can involve more than one date of initial application. Therefore this paragraph may result in disclosure on more than one date of initial application.

42K In the reporting period that an entity first applies the classification and measurement requirements for financial assets in HKFRS 9 (ie when the entity transitions from HKAS 39 to HKFRS 9 for financial assets), it shall present the disclosures set out in paragraphs 42L–42O of this HKFRS as required by paragraph 7.2.15 of HKFRS 9.

42L When required by paragraph 42K, an entity shall disclose the changes in the classifications of financial assets and financial liabilities as at the date of initial application of HKFRS 9, showing separately:

- (a) the changes in the carrying amounts on the basis of their measurement categories in accordance with HKAS 39 (ie not resulting from a change in measurement attribute on transition to HKFRS 9); and
- (b) the changes in the carrying amounts arising from a change in measurement attribute on transition to HKFRS 9.

The disclosures in this paragraph need not be made after the annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in HKFRS 9.

42M When required by paragraph 42K, an entity shall disclose the following for financial assets and financial liabilities that have been reclassified so that they are measured at amortised cost and, in the case of financial assets, that have been reclassified out of fair value through profit or loss so that they are measured at fair value through other comprehensive income, as a result of the transition to HKFRS 9:

- (a) the fair value of the financial assets or financial liabilities at the end of the reporting period; and
- (b) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets or financial liabilities had not been reclassified.

The disclosures in this paragraph need not be made after the annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in HKFRS 9.

42N When required by paragraph 42K, an entity shall disclose the following for financial assets and financial liabilities that have been reclassified out of the fair value through profit or loss category as a result of the transition to HKFRS 9:

- (a) the effective interest rate determined on the date of initial application; and
- (b) the interest revenue or expense recognised.

If an entity treats the fair value of a financial asset or a financial liability as the new gross carrying amount at the date of initial application (see paragraph 7.2.11 of HKFRS 9), the disclosures in this paragraph shall be made for each reporting period until derecognition. Otherwise, the disclosures in this paragraph need not be made after the annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in HKFRS 9.

42O When an entity presents the disclosures set out in paragraphs 42K–42N, those disclosures, and the disclosures in paragraph 25 of this HKFRS, must permit reconciliation between:

(a) the measurement categories presented in accordance with HKAS 39 and HKFRS 9; and

(b) the class of financial instrument

as at the date of initial application.

42P On the date of initial application of Section 5.5 of HKFRS 9, an entity is required to disclose information that would permit the reconciliation of the ending impairment allowances in accordance with HKAS 39 and the provisions in accordance with HKAS 37 to the opening loss allowances determined in accordance with HKFRS 9. For financial assets, this disclosure shall be provided by the related financial assets' measurement categories in accordance with HKAS 39 and HKFRS 9, and shall show separately the effect of the changes in the measurement category on the loss allowance at that date.

42Q In the reporting period that includes the date of initial application of HKFRS 9, an entity is not required to disclose the line item amounts that would have been reported in accordance with the classification and measurement requirements (which includes the requirements related to amortised cost measurement of financial assets and impairment in Sections 5.4 and 5.5 of HKFRS 9) of:

(a) HKFRS 9 for prior periods; and

(b) HKAS 39 for the current period.

42R In accordance with paragraph 7.2.4 of HKFRS 9, if it is impracticable (as defined in HKAS 8) at the date of initial application of HKFRS 9 for an entity to assess a modified time value of money element in accordance with paragraphs B4.1.9B–B4.1.9D of HKFRS 9 based on the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs B4.1.9B–B4.1.9D of HKFRS 9. An entity shall disclose the carrying amount at the reporting date of the financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs B4.1.9B–B4.1.9D of HKFRS 9 until those financial assets are derecognised.

42S In accordance with paragraph 7.2.5 of HKFRS 9, if it is impracticable (as defined in HKAS 8) at the date of initial application for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraphs B4.1.12(c) of HKFRS 9 based on the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12 of HKFRS 9. An entity shall disclose the carrying amount at the reporting date of the financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12 of HKFRS 9 until those financial assets are derecognised.

Effective date and transition

- 43 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2007. Earlier application is encouraged. If an entity applies this HKFRS for an earlier period, it shall disclose that fact.
- 44 If an entity applies this HKFRS for annual periods beginning before 1 January 2006, it need not present comparative information for the disclosures required by paragraphs 31-42 about the nature and extent of risks arising from financial instruments.
- 44A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 20, 21, 23(c) and (d), 27(c) and B5 of Appendix B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 44B HKFRS 3 (as revised in 2008) deleted paragraph 3(c). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period. However, the amendment does not apply to contingent consideration that arose from a business combination for which the acquisition date preceded the application of HKFRS 3 (revised 2008). Instead, an entity shall account for such consideration in accordance with paragraphs 65A–65E of HKFRS 3 (as amended in 2010).
- 44C An entity shall apply the amendment in paragraph 3 for annual periods beginning on or after 1 January 2009. If an entity applies *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1), issued in June 2008, for an earlier period, the amendment in paragraph 3 shall be applied for that earlier period.
- 44D Paragraph 3(a) was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact and apply for that earlier period the amendments to paragraph 1 of HKAS 28, paragraph 1 of HKAS 31 and paragraph 4 of HKAS 32 issued in October 2008. An entity is permitted to apply the amendment prospectively.
- 44E ~~*Reclassification of Financial Assets* (Amendments to HKAS 39 and HKFRS 7), issued in October 2008, amended paragraph 12 and added paragraph 12A. An entity shall apply those amendments on or after 1 July 2008.~~[Deleted]
- 44F ~~*Reclassification of Financial Assets—Effective Date and Transition* (Amendments to HKAS 39 and HKFRS 7), issued in December 2008, amended paragraph 44E. An entity shall apply that amendment on or after 1 July 2008.~~[Deleted]

- 44G *Improving Disclosures about Financial Instruments* (Amendments to HKFRS 7), issued in March 2009, amended paragraphs 27, 39 and B11 and added paragraphs 27A, 27B, B10A and B11A–B11F. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. An entity need not provide the disclosures required by the amendments for:
- (a) any annual or interim period, including any statement of financial position, presented within an annual comparative period ending before 31 December 2009, or
 - (b) any statement of financial position as at the beginning of the earliest comparative period as at a date before 31 December 2009.
- Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.*
- 44H-44J ~~[These paragraphs refer to amendments with an effective date after 1 January 2013, and are therefore not included in this edition.] [Deleted]~~
- 44K Paragraph 44B was amended by *Improvements to HKFRSs* issued in May 2010. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted.
- 44L *Improvements to HKFRSs* issued in May 2010 added paragraph 32A and amended paragraphs 34 and 36–38. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- 44M *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7), issued in October 2010, deleted paragraph 13 and added paragraphs 42A–42H and B29–B39. An entity shall apply those amendments for annual periods beginning on or after 1 July 2011. Earlier application is permitted. If an entity applies the amendments from an earlier date, it shall disclose that fact. An entity need not provide the disclosures required by those amendments for any period presented that begins before the date of initial application of the amendments.
- 44N ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.] [Deleted]~~
- 44O HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraph 3. An entity shall apply that amendment when it applies HKFRS 10 and HKFRS 11.
- 44P HKFRS 13, issued in June 2011, amended paragraphs 3, 28 and 29 and Appendix A and deleted paragraphs 27–27B. An entity shall apply those amendments when it applies HKFRS 13.
- 44Q *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 27B. An entity shall apply that amendment when it applies HKAS 1 as amended in June 2011.
- 44R *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to HKFRS 7), issued in December 2011, added paragraphs 13A–13F and B40–B53. An entity shall apply those amendments for annual periods beginning on or after 1 January 2013. An entity shall provide the disclosures required by those amendments retrospectively.

* Paragraph 44G was amended as a consequence of *Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters* (Amendment to HKFRS 1) issued in February 2010. The HKICPA amended paragraph 44G to clarify its conclusions and intended transition for *Improving Disclosures about Financial Instruments* (Amendments to HKFRS 7).

~~44S– [These paragraphs refer to amendments with an effective date after 1 January 2015,~~
~~44W and are therefore not included in this edition.] [Deleted]~~

Withdrawal of HKAS 30–

44X *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraph 3. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies that amendment earlier it shall also apply all amendments included in *Investment Entities* at the same time.

~~44Y–ZA [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.] [Deleted]~~

44Z HKFRS 9, as issued in September 2014, amended paragraphs 2–5, 8–11, 14, 20, 28–30, 36, 42C–42E, Appendix A and paragraphs B1, B5, B9, B10, B22 and B27, deleted paragraphs 12, 12A, 16, 22–24, 37, 44E, 44F, 44H–44J, 44N, 44S–44W, 44Y, B4 and Appendix D and added paragraphs 5A, 10A, 11A, 11B, 12B–12D, 16A, 20A, 21A–21D, 22A–22C, 23A–23F, 24A–24G, 35A–35N, 42I–42S, 44ZA and B8A–B8J. An entity shall apply those amendments when it applies HKFRS 9. Those amendments need not be applied to comparative information provided for periods before the date of initial application of HKFRS 9.

44ZA In accordance with paragraph 7.1.2 of HKFRS 9, for annual reporting periods prior to 1 January 2018, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of HKFRS 9 without applying the other requirements in HKFRS 9. If an entity elects to apply only those paragraphs of HKFRS 9, it shall disclose that fact and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of this HKFRS (as amended by HKFRS 9 (2010)).

44AA *Annual Improvements to HKFRSs 2012–2014 Cycle*, issued in October 2014, amended paragraphs 44R and B30 and added paragraph B30A. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2016, except that an entity need not apply the amendments to paragraphs B30 and B30A for any period presented that begins before the annual period for which the entity first applies those amendments. Earlier application of the amendments to paragraphs 44R, B30 and B30A is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.

44BB *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraphs 21 and B5. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application of those amendments is permitted.

Withdrawal of HKAS 30

45 This HKFRS supersedes HKAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
<u>credit risk rating grades</u>	<u>Rating of credit risk based on the risk of a default occurring on the financial instrument.</u>
currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk , interest rate risk and other price risk .
other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or by factors affecting all similar financial instruments traded in the market.
~~past due~~	~~A financial asset is past due when a counterparty has failed to make a payment when contractually due.~~

The following terms are defined in paragraph 11 of HKAS 32, ~~or paragraph 9 of HKAS 39, Appendix A of HKFRS 9 or Appendix A of HKFRS 13~~ and are used in the HKFRS with the meaning specified in HKAS 32 ~~and, HKAS 39, HKFRS 9 and HKFRS 13.~~

- amortised cost of a financial asset or financial liability
- ~~available for sale financial assets~~contract asset
- credit-impaired financial assets
- derecognition
- derivative
- dividends
- effective interest method
- equity instrument

- expected credit losses
- fair value
- financial asset
- ~~financial asset or financial liability at fair value through profit or loss~~
- ~~financial asset or financial liability held for trading~~
- financial guarantee contract
- financial instrument
- ~~financial liability~~
- financial liability at fair value through profit or loss
- ~~forecast transaction~~
- gross carrying amount of a financial asset
- hedging instrument
- ~~held to maturity investments~~ held for trading
- impairment gains or losses
- loss allowance
- past due
- purchased or originated credit-impaired financial assets
- reclassification date
- ~~loans and receivables~~
- regular way purchase or sale

Appendix B

Application guidance

This appendix is an integral part of the HKFRS.

Classes of financial instruments and level of disclosure (paragraph 6)

- B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in ~~HKAS 39~~ HKFRS 9 (which determine how financial instruments are measured and where changes in fair value are recognised).
- B2 In determining classes of financial instrument, an entity shall, at a minimum:
- (a) distinguish instruments measured at amortised cost from those measured at fair value.
 - (b) treat as a separate class or classes those financial instruments outside the scope of this HKFRS.
- B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this HKFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

~~Significance of financial instruments for financial position and performance~~

~~Financial liabilities at fair value through profit or loss (paragraphs 10 and 11)~~

- B4 ~~[Deleted] If an entity designates a financial liability as at fair value through profit or loss, paragraph 10(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph 10(a)(i) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:~~
- ~~(a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.~~
 - ~~(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).~~

- (c) ~~The difference between the observed market price of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.~~

~~This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph 10(a).~~

Other disclosure — accounting policies (paragraph 21)

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

- (a) ~~for financial assets or financial liabilities designated as at fair value through profit or loss:~~
- (i) ~~the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss;~~
 - (ii) ~~the criteria for so designating such financial assets or financial liabilities on initial recognition; and~~
 - (iii) ~~how the entity has satisfied the conditions in paragraph 9, 11A or 12 of HKAS 39/4.2.2 of HKFRS 9 for such designation. For instruments designated in accordance with paragraph (b)(i) of the definition of a financial asset or financial liability at fair value through profit or loss in HKAS 39, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph (b)(ii) of the definition of a financial asset or financial liability at fair value through profit or loss in HKAS 39, that disclosure includes a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.~~
- (aa) ~~for financial assets designated as measured at fair value through profit or loss:~~
- (i) ~~the nature of the financial assets the entity has designated as measured at fair value through profit or loss; and~~
 - (ii) ~~how the entity has satisfied the criteria in paragraph 4.1.5 of HKFRS 9 for such designation.~~
- (b) ~~[deleted]the criteria for designating financial assets as available for sale.~~
- (c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 38 of HKAS 39/3.1.2 of HKFRS 9).
- (d) ~~[deleted]when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:~~
- (i) ~~the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a~~

~~write down, increased directly) and when the allowance account is used; and~~

~~(ii) the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 16).~~

- (e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.
- (f) ~~[deleted]the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 20(e)).~~
- (g) ~~[deleted]when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms.~~

Paragraph 122 of HKAS 1 (as revised in 2007) also requires entities to disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Nature and extent of risks arising from financial instruments (paragraphs 31-42)

- B6 The disclosures required by paragraphs 31-42 shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Quantitative disclosures (paragraph 34)

- B7 Paragraph 34(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to key management personnel of the entity. When an entity uses several methods to manage a risk exposure, the entity shall disclose information using the method or methods that provide the most relevant and reliable information. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* discusses relevance and reliability.
- B8 Paragraph 34(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity. Disclosure of concentrations of risk shall include:
- (a) a description of how management determines concentrations;
 - (b) a description of the shared characteristic that identifies each concentration (eg counterparty, geographical area, currency or market); and
 - (c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Credit risk management practices (paragraphs 35F–35G)

B8A Paragraph 35F(b) requires the disclosure of information about how an entity has defined default for different financial instruments and the reasons for selecting those definitions. In accordance with paragraph 5.5.9 of HKFRS 9, the determination of whether lifetime expected credit losses should be recognised is based on the increase in the risk of a default occurring since initial recognition. Information about an entity's definitions of default that will assist users of financial statements in understanding how an entity has applied the expected credit loss requirements in HKFRS 9 may include:

- (a) the qualitative and quantitative factors considered in defining default;
- (b) whether different definitions have been applied to different types of financial instruments; and
- (c) assumptions about the cure rate (ie the number of financial assets that return to a performing status) after a default occurred on the financial asset.

B8B To assist users of financial statements in evaluating an entity's restructuring and modification policies, paragraph 35F(f)(ii) requires the disclosure of information about how an entity monitors the extent to which the loss allowance on financial assets previously disclosed in accordance with paragraph 35F(f)(i) are subsequently measured at an amount equal to lifetime expected credit losses in accordance with paragraph 5.5.3 of HKFRS 9. Quantitative information that will assist users in understanding the subsequent increase in credit risk of modified financial assets may include information about modified financial assets meeting the criteria in paragraph 35F(f)(i) for which the loss allowance has reverted to being measured at an amount equal to lifetime expected credit losses (ie a deterioration rate).

B8C Paragraph 35G(a) requires the disclosure of information about the basis of inputs and assumptions and the estimation techniques used to apply the impairment requirements in HKFRS 9. An entity's assumptions and inputs used to measure expected credit losses or determine the extent of increases in credit risk since initial recognition may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral.

Changes in the loss allowance (paragraph 35H)

B8D In accordance with paragraph 35H, an entity is required to explain the reasons for the changes in the loss allowance during the period. In addition to the reconciliation from the opening balance to the closing balance of the loss allowance, it may be necessary to provide a narrative explanation of the changes. This narrative explanation may include an analysis of the reasons for changes in the loss allowance during the period, including:

- (a) the portfolio composition;
- (b) the volume of financial instruments purchased or originated; and
- (c) the severity of the expected credit losses.

B8E For loan commitments and financial guarantee contracts the loss allowance is recognised as a provision. An entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected

credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

Collateral (paragraph 35K)

B8F Paragraph 35K requires the disclosure of information that will enable users of financial statements to understand the effect of collateral and other credit enhancements on the amount of expected credit losses. An entity is neither required to disclose information about the fair value of collateral and other credit enhancements nor is it required to quantify the exact value of the collateral that was included in the calculation of expected credit losses (ie the loss given default).

B8G A narrative description of collateral and its effect on amounts of expected credit losses might include information about:

- (a) the main types of collateral held as security and other credit enhancements (examples of the latter being guarantees, credit derivatives and netting agreements that do not qualify for offset in accordance with HKAS 32);
- (b) the volume of collateral held and other credit enhancements and its significance in terms of the loss allowance;
- (c) the policies and processes for valuing and managing collateral and other credit enhancements;
- (d) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- (e) information about risk concentrations within the collateral and other credit enhancements.

Credit risk exposure (paragraphs 35M–35N)

B8H Paragraph 35M requires the disclosure of information about an entity's credit risk exposure and significant concentrations of credit risk at the reporting date. A concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. An entity should provide information that enables users of financial statements to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments such as concentration to particular risks. This could include, for example, loan-to-value groupings, geographical, industry or issuer-type concentrations.

B8I The number of credit risk rating grades used to disclose the information in accordance with paragraph 35M shall be consistent with the number that the entity reports to key management personnel for credit risk management purposes. If past due information is the only borrower-specific information available and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 5.5.11 of HKFRS 9, an entity shall provide an analysis by past due status for those financial assets.

B8J When an entity has measured expected credit losses on a collective basis, the entity may not be able to allocate the gross carrying amount of individual financial assets or the exposure to credit risk on loan commitments and financial guarantee contracts to the credit risk rating grades for which lifetime expected credit losses are recognised. In

that case, an entity should apply the requirement in paragraph 35M to those financial instruments that can be directly allocated to a credit risk rating grade and disclose separately the gross carrying amount of financial instruments for which lifetime expected credit losses have been measured on a collective basis.

Maximum credit risk exposure (paragraph 36(a))

- B9 Paragraphs 35K(a) and 36(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:
- (a) any amounts offset in accordance with HKAS 32; and
 - (b) ~~any impairment losses allowance~~ recognised in accordance with ~~HKAS 39~~HKFRS 9.
- B10 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:
- (a) ~~granting loans and receivables~~ to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
 - (b) entering into derivative contracts, eg foreign exchange contracts, interest rate swaps and credit derivatives. When the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount.
 - (c) granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.
 - (d) making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

Quantitative liquidity risk disclosures (paragraphs 34(a) and 39(a) and (b))

- B10A In accordance with paragraph 34(a) an entity discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel. An entity shall explain how those data are determined. If the outflows of cash (or another financial asset) included in those data could either:
- (a) occur significantly earlier than indicated in the data, or
 - (b) be for significantly different amounts from those indicated in the data (eg for a derivative that is included in the data on a net settlement basis but for which the counterparty has the option to require gross settlement),

the entity shall state that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analyses required by paragraph 39(a) or (b).

- B11 In preparing the maturity analyses required by paragraph 39(a) and (b), an entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:
- (a) not later than one month;
 - (b) later than one month and not later than three months;
 - (c) later than three months and not later than one year; and
 - (d) later than one year and not later than five years.
- B11A In complying with paragraph 39(a) and (b), an entity shall not separate an embedded derivative from a hybrid (combined) financial instrument. For such an instrument, an entity shall apply paragraph 39(a).
- B11B Paragraph 39(b) requires an entity to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the timing of the cash flows. For example, this would be the case for:
- (a) an interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability.
 - (b) all loan commitments.
- B11C Paragraph 39(a) and (b) requires an entity to disclose maturity analyses for financial liabilities that show the remaining contractual maturities for some financial liabilities. In this disclosure:
- (a) when a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band.
 - (b) when an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.
 - (c) for issued financial guarantee contracts the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.
- B11D The contractual amounts disclosed in the maturity analyses as required by paragraph 39(a) and (b) are the contractual undiscounted cash flows, for example:
- (a) gross finance lease obligations (before deducting finance charges);
 - (b) prices specified in forward agreements to purchase financial assets for cash;
 - (c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;
 - (d) contractual amounts to be exchanged in a derivative financial instrument (eg a currency swap) for which gross cash flows are exchanged; and
 - (e) gross loan commitments.

Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in that statement is based on discounted cash flows. When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the end of the period.

- B11E Paragraph 39(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph 39(a) and (b). An entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk (eg financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.
- B11F Other factors that an entity might consider in providing the disclosure required in paragraph 39(c) include, but are not limited to, whether the entity:
- (a) has committed borrowing facilities (eg commercial paper facilities) or other lines of credit (eg stand-by credit facilities) that it can access to meet liquidity needs;
 - (b) holds deposits at central banks to meet liquidity needs;
 - (c) has very diverse funding sources;
 - (d) has significant concentrations of liquidity risk in either its assets or its funding sources;
 - (e) has internal control processes and contingency plans for managing liquidity risk;
 - (f) has instruments that include accelerated repayment terms (eg on the downgrade of the entity's credit rating);
 - (g) has instruments that could require the posting of collateral (eg margin calls for derivatives);
 - (h) has instruments that allow the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares; or
 - (i) has instruments that are subject to master netting agreements.

B12-B16 [Deleted]

Market risk — sensitivity analysis (paragraphs 40 and 41)

- B17 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. In accordance with paragraph B3, an entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:
- (a) an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.

- (b) an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

B18 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable (eg prevailing market interest rates, currency rates, equity prices or commodity prices). For this purpose:

- (a) entities are not required to determine what the profit or loss for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on profit or loss and equity at the end of the reporting period assuming that a reasonably possible change in the relevant risk variable had occurred at the end of the reporting period and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on profit or loss (ie interest expense) for the current year if interest rates had varied by reasonably possible amounts.
- (b) entities are not required to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

B19 In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

- (a) the economic environments in which it operates. A reasonably possible change should not include remote or “worst case” scenarios or “stress tests”. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5 per cent and an entity determines that a fluctuation in interest rates of ± 50 basis points is reasonably possible. It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5 per cent or 5.5 per cent. In the next period, interest rates have increased to 5.5 per cent. The entity continues to believe that interest rates may fluctuate by ± 50 basis points (ie that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5 per cent or 6 per cent. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ± 50 basis points, unless there is evidence that interest rates have become significantly more volatile.
- (b) the time frame over which it is making the assessment. The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

B20 Paragraph 41 permits an entity to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with paragraph 41(a) by disclosing the type of value-at-risk model used (eg whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (eg the holding period and confidence level). Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of

how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

- B21 An entity shall provide sensitivity analyses for the whole of its business, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest rate risk

- B22 *Interest rate risk* arises on interest-bearing financial instruments recognised in the statement of financial position (eg ~~loans and receivables and~~ debt instruments acquired or issued) and on some financial instruments not recognised in the statement of financial position (eg some loan commitments).

Currency risk

- B23 *Currency risk* (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, ie in a currency other than the functional currency in which they are measured. For the purpose of this HKFRS, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

- B24 A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other price risk

- B25 *Other price risk* arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph 40, an entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

- B26 Two examples of financial instruments that give rise to equity price risk are (a) a holding of equities in another entity and (b) an investment in a trust that in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

- B27 In accordance with paragraph 40(a), the sensitivity of profit or loss (that arises, for example, from instruments ~~classified as measured~~ at fair value through profit or loss ~~and impairments of available-for-sale financial assets~~) is disclosed separately from the sensitivity of ~~equity~~ other comprehensive income (that arises, for example, from ~~instruments classified as available-for-sale investments in equity instruments whose changes in fair value are presented in other comprehensive income~~).

- B28 Financial instruments that an entity classifies as equity instruments are not remeasured. Neither profit or loss nor equity will be affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Derecognition (paragraphs 42C–42H)

Continuing involvement (paragraph 42C)

- B29 The assessment of continuing involvement in a transferred financial asset for the purposes of the disclosure requirements in paragraphs 42E–42H is made at the level of the reporting entity. For example, if a subsidiary transfers to an unrelated third party a financial asset in which the parent of the subsidiary has continuing

involvement, the subsidiary does not include the parent's involvement in the assessment of whether it has continuing involvement in the transferred asset in its separate or individual financial statements (ie when the subsidiary is the reporting entity). However, a parent would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary in determining whether it has continuing involvement in the transferred asset in its consolidated financial statements (ie when the reporting entity is the group).

- B30 An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future. The term 'payment' in this context does not include cash flows of the transferred financial asset that an entity collects and is required to remit to the transferee.
- B30A When an entity transfers a financial asset, the entity may retain the right to service that financial asset for a fee that is included in, for example, a servicing contract. The entity assesses the servicing contract in accordance with the guidance in paragraphs 42C and B30 to decide whether the entity has continuing involvement as a result of the servicing contract for the purposes of the disclosure requirements. For example, a servicer will have continuing involvement in the transferred financial asset for the purposes of the disclosure requirements if the servicing fee is dependent on the amount or timing of the cash flows collected from the transferred financial asset. Similarly, a servicer has continuing involvement for the purposes of the disclosure requirements if a fixed fee would not be paid in full because of non-performance of the transferred financial asset. In these examples, the servicer has an interest in the future performance of the transferred financial asset. This assessment is independent of whether the fee to be received is expected to compensate the entity adequately for performing the servicing.
- B31 Continuing involvement in a transferred financial asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer.

Transferred financial assets that are not derecognised in their entirety (paragraph 42D)

- B32 Paragraph 42D requires disclosures when part or all of the transferred financial assets do not qualify for derecognition. Those disclosures are required at each reporting date at which the entity continues to recognise the transferred financial assets, regardless of when the transfers occurred.

Types of continuing involvement (paragraphs 42E–42H)

- B33 Paragraphs 42E–42H require qualitative and quantitative disclosures for each type of continuing involvement in derecognised financial assets. An entity shall aggregate its continuing involvement into types that are representative of the entity's exposure to risks. For example, an entity may aggregate its continuing involvement by type of financial instrument (eg guarantees or call options) or by type of transfer (eg factoring of receivables, securitisations and securities lending).

Maturity analysis for undiscounted cash outflows to repurchase transferred assets (paragraph 42E(e))

- B34 Paragraph 42E(e) requires an entity to disclose a maturity analysis of the undiscounted cash outflows to repurchase derecognised financial assets or other amounts payable to the transferee in respect of the derecognised financial assets, showing the remaining contractual maturities of the entity's continuing involvement. This analysis distinguishes cash flows that are required to be paid (eg forward contracts), cash flows that the entity may be required to pay (eg written put options) and cash flows that the entity might choose to pay (eg purchased call options).
- B35 An entity shall use its judgement to determine an appropriate number of time bands in preparing the maturity analysis required by paragraph 42E(e). For example, an entity might determine that the following maturity time bands are appropriate:
- (a) not later than one month;
 - (b) later than one month and not later than three months;
 - (c) later than three months and not later than six months;
 - (d) later than six months and not later than one year;
 - (e) later than one year and not later than three years;
 - (f) later than three years and not later than five years; and
 - (g) more than five years.
- B36 If there is a range of possible maturities, the cash flows are included on the basis of the earliest date on which the entity can be required or is permitted to pay.

Qualitative information (paragraph 42E(f))

- B37 The qualitative information required by paragraph 42E(f) includes a description of the derecognised financial assets and the nature and purpose of the continuing involvement retained after transferring those assets. It also includes a description of the risks to which an entity is exposed, including:
- (a) a description of how the entity manages the risk inherent in its continuing involvement in the derecognised financial assets.
 - (b) whether the entity is required to bear losses before other parties, and the ranking and amounts of losses borne by parties whose interests rank lower than the entity's interest in the asset (ie its continuing involvement in the asset).
 - (c) a description of any triggers associated with obligations to provide financial support or to repurchase a transferred financial asset.

Gain or loss on derecognition (paragraph 42G(a))

- B38 Paragraph 42G(a) requires an entity to disclose the gain or loss on derecognition relating to financial assets in which the entity has continuing involvement. The entity shall disclose if a gain or loss on derecognition arose because the fair values of the components of the previously recognised asset (ie the interest in the asset derecognised and the interest retained by the entity) were different from the fair value of the previously recognised asset as a whole. In that situation, the entity shall also

disclose whether the fair value measurements included significant inputs that were not based on observable market data, as described in paragraph 27A.

Supplementary information (paragraph 42H)

- B39 The disclosures required in paragraphs 42D–42G may not be sufficient to meet the disclosure objectives in paragraph 42B. If this is the case, the entity shall disclose whatever additional information is necessary to meet the disclosure objectives. The entity shall decide, in the light of its circumstances, how much additional information it needs to provide to satisfy the information needs of users and how much emphasis it places on different aspects of the additional information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

Offsetting financial assets and financial liabilities (paragraphs 13A–13F)

Scope (paragraph 13A)

- B40 The disclosures in paragraphs 13B–13E are required for all recognised financial instruments that are set off in accordance with paragraph 42 of HKAS 32. In addition, financial instruments are within the scope of the disclosure requirements in paragraphs 13B–13E if they are subject to an enforceable master netting arrangement or similar agreement that covers similar financial instruments and transactions, irrespective of whether the financial instruments are set off in accordance with paragraph 42 of HKAS 32.
- B41 The similar agreements referred to in paragraphs 13A and B40 include derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral. The similar financial instruments and transactions referred to in paragraph B40 include derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities borrowing, and securities lending agreements. Examples of financial instruments that are not within the scope of paragraph 13A are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement.

Disclosure of quantitative information for recognised financial assets and recognised financial liabilities within the scope of paragraph 13A (paragraph 13C)

- B42 Financial instruments disclosed in accordance with paragraph 13C may be subject to different measurement requirements (for example, a payable related to a repurchase agreement may be measured at amortised cost, while a derivative will be measured at fair value). An entity shall include instruments at their recognised amounts and describe any resulting measurement differences in the related disclosures.

Disclosure of the gross amounts of recognised financial assets and recognised financial liabilities within the scope of paragraph 13A (paragraph 13C(a))

- B43 The amounts required by paragraph 13C(a) relate to recognised financial instruments that are set off in accordance with paragraph 42 of HKAS 32. The amounts required by paragraph 13C(a) also relate to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement irrespective of whether they meet the offsetting criteria. However, the disclosures required by paragraph 13C(a) do not relate to any amounts recognised as a result of collateral agreements

that do not meet the offsetting criteria in paragraph 42 of HKAS 32. Instead, such amounts are required to be disclosed in accordance with paragraph 13C(d).

Disclosure of the amounts that are set off in accordance with the criteria in paragraph 42 of HKAS 32 (paragraph 13C(b))

- B44 Paragraph 13C(b) requires that entities disclose the amounts set off in accordance with paragraph 42 of HKAS 32 when determining the net amounts presented in the statement of financial position. The amounts of both the recognised financial assets and the recognised financial liabilities that are subject to set-off under the same arrangement will be disclosed in both the financial asset and financial liability disclosures. However, the amounts disclosed (in, for example, a table) are limited to the amounts that are subject to set-off. For example, an entity may have a recognised derivative asset and a recognised derivative liability that meet the offsetting criteria in paragraph 42 of HKAS 32. If the gross amount of the derivative asset is larger than the gross amount of the derivative liability, the financial asset disclosure table will include the entire amount of the derivative asset (in accordance with paragraph 13C(a)) and the entire amount of the derivative liability (in accordance with paragraph 13C(b)). However, while the financial liability disclosure table will include the entire amount of the derivative liability (in accordance with paragraph 13C(a)), it will only include the amount of the derivative asset (in accordance with paragraph 13C(b)) that is equal to the amount of the derivative liability.

Disclosure of the net amounts presented in the statement of financial position (paragraph 13C(c))

- B45 If an entity has instruments that meet the scope of these disclosures (as specified in paragraph 13A), but that do not meet the offsetting criteria in paragraph 42 of HKAS 32, the amounts required to be disclosed by paragraph 13C(c) would equal the amounts required to be disclosed by paragraph 13C(a).
- B46 The amounts required to be disclosed by paragraph 13C(c) must be reconciled to the individual line item amounts presented in the statement of financial position. For example, if an entity determines that the aggregation or disaggregation of individual financial statement line item amounts provides more relevant information, it must reconcile the aggregated or disaggregated amounts disclosed in paragraph 13C(c) back to the individual line item amounts presented in the statement of financial position.

Disclosure of the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 13C(b) (paragraph 13C(d))

- B47 Paragraph 13C(d) requires that entities disclose amounts that are subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 13C(b). Paragraph 13C(d)(i) refers to amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of HKAS 32 (for example, current rights of set-off that do not meet the criterion in paragraph 42(b) of HKAS 32, or conditional rights of set-off that are enforceable and exercisable only in the event of default, or only in the event of insolvency or bankruptcy of any of the counterparties).
- B48 Paragraph 13C(d)(ii) refers to amounts related to financial collateral, including cash collateral, both received and pledged. An entity shall disclose the fair value of those financial instruments that have been pledged or received as collateral. The amounts disclosed in accordance with paragraph 13C(d)(ii) should relate to the actual collateral received or pledged and not to any resulting payables or receivables recognised to return or receive back such collateral.

Limits on the amounts disclosed in paragraph 13C(d) (paragraph 13D)

- B49 When disclosing amounts in accordance with paragraph 13C(d), an entity must take into account the effects of over-collateralisation by financial instrument. To do so, the entity must first deduct the amounts disclosed in accordance with paragraph 13C(d)(i) from the amount disclosed in accordance with paragraph 13C(c). The entity shall then limit the amounts disclosed in accordance with paragraph 13C(d)(ii) to the remaining amount in paragraph 13C(c) for the related financial instrument. However, if rights to collateral can be enforced across financial instruments, such rights can be included in the disclosure provided in accordance with paragraph 13D.

Description of the rights of set-off subject to enforceable master netting arrangements and similar agreements (paragraph 13E)

- B50 An entity shall describe the types of rights of set-off and similar arrangements disclosed in accordance with paragraph 13C(d), including the nature of those rights. For example, an entity shall describe its conditional rights. For instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in paragraph 42 of HKAS 32, the entity shall describe the reason(s) why the criteria are not met. For any financial collateral received or pledged, the entity shall describe the terms of the collateral agreement (for example, when the collateral is restricted).

Disclosure by type of financial instrument or by counterparty

- B51 The quantitative disclosures required by paragraph 13C(a)–(e) may be grouped by type of financial instrument or transaction (for example, derivatives, repurchase and reverse repurchase agreements or securities borrowing and securities lending agreements).
- B52 Alternatively, an entity may group the quantitative disclosures required by paragraph 13C(a)–(c) by type of financial instrument, and the quantitative disclosures required by paragraph 13C(c)–(e) by counterparty. If an entity provides the required information by counterparty, the entity is not required to identify the counterparties by name. However, designation of counterparties (Counterparty A, Counterparty B, Counterparty C, etc) shall remain consistent from year to year for the years presented to maintain comparability. Qualitative disclosures shall be considered so that further information can be given about the types of counterparties. When disclosure of the amounts in paragraph 13C(c)–(e) is provided by counterparty, amounts that are individually significant in terms of total counterparty amounts shall be separately disclosed and the remaining individually insignificant counterparty amounts shall be aggregated into one line item.

Other

- B53 The specific disclosures required by paragraphs 13C–13E are minimum requirements. To meet the objective in paragraph 13B an entity may need to supplement them with additional (qualitative) disclosures, depending on the terms of the enforceable master netting arrangements and related agreements, including the nature of the rights of set-off, and their effect or potential effect on the entity's financial position.

Appendix C

Amendments to other HKFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2007. If an entity applies the HKFRS for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 7*

Financial Instruments: Disclosures



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Basis for Conclusions

HKFRS 7 *Financial Instruments: Disclosures*

HKFRS 7 is based on IFRS 7 *Financial Instruments: Disclosures*. In approving HKFRS 7, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 7. Accordingly, there are no significant differences between HKFRS 7 and IFRS 7. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 7 referred to below generally correspond with those in HKFRS 7.

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Basis for Conclusions on IFRS 7 *Financial Instruments: Disclosures*

This Basis for Conclusions accompanies, but is not part of, IFRS 7.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements (as revised in 2007).

The requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments, and IFRS 7 was amended accordingly. The text of this Basis for Conclusions has been amended for consistency with those changes.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 7 *Financial Instruments: Disclosures*. Individual Board members gave greater weight to some factors than to others.
- BC2 During the late 1990s, the need for a comprehensive review of IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* became apparent. The Board's predecessor, the International Accounting Standards Committee (IASC), issued a number of Standards that addressed, more comprehensively, some of the topics previously addressed only for banks in IAS 30. Also, fundamental changes were taking place in the financial services industry and in the way in which financial institutions manage their activities and risk exposures. This made it increasingly difficult for users of banks' financial statements to assess and compare their financial position and performance, their associated risk exposures, and their processes for measuring and managing those risks.
- BC3 In 1999 IASC added a project to its agenda to revise IAS 30 and in 2000 it appointed a steering committee.
- BC4 In 2001 the Board added this project to its agenda. To assist and advise it, the Board retained the IAS 30 steering committee, renamed the Financial Activities Advisory Committee (FAAC), as an expert advisory group. FAAC members had experience and expertise in banks, finance companies and insurance companies and included auditors, financial analysts, preparers and regulators. The FAAC's role was:
- (a) to provide input from the perspective of preparers and auditors of financial statements of entities that have significant exposures to financial instruments; and
 - (b) to assist the Board in developing a standard and implementation guidance for risk disclosures arising from financial instruments and for other related disclosures.
- BC5 The Board published its proposals in July 2004 as ED 7 *Financial Instruments: Disclosures*. The deadline for comments was 27 October 2004. The Board received 105 comment letters. After reviewing the responses, the Board issued IFRS 7 in August 2005.
- BC5A In October 2008 the Board published an exposure draft *Improving Disclosures about Financial Instruments* (proposed amendments to IFRS 7). The aim of the proposed amendments was to enhance disclosures about fair value and liquidity risk. The Board received 89 comment letters. After reviewing the responses, the Board issued amendments to IFRS 7 in March 2009. The Board decided to require application of the amendments for periods beginning on or after 1 January 2009. The Board noted that,

although the effective date of IFRSs and amendments to IFRSs is usually 6–18 months after issue, the urgent need for enhanced disclosures about financial instruments demanded earlier application.

BC5B In January 2011 the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), published the exposure draft *Offsetting Financial Assets and Financial Liabilities*. This was in response to requests from users of financial statements and recommendations from the Financial Stability Board to achieve convergence of the boards' requirements for offsetting financial assets and financial liabilities. The different requirements result in a significant difference between amounts presented in statements of financial position prepared in accordance with IFRSs and amounts presented in statements of financial position prepared in accordance with US GAAP, particularly for entities that have large amounts of derivative activities. The proposals in the exposure draft would have replaced the requirements for offsetting financial assets and financial liabilities and would have established a common approach with the FASB. After considering the responses to the exposure draft, the boards decided to maintain their respective offsetting models. However, to meet the needs of users of financial statements, the boards agreed jointly on additional disclosures to enable users of financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with an entity's recognised financial assets and recognised financial liabilities, on the entity's financial position. *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7) was issued in December 2011 and is effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods.

Scope (paragraphs 3-5)

The entities to which the IFRS applies

BC6 Although IFRS 7 arose from a project to revise IAS 30 (a Standard that applied only to banks and similar financial institutions), it applies to all entities that have financial instruments. The Board observed that the reduction in regulatory barriers in many countries and increasing competition between banks, non-bank financial services firms, and financial conglomerates have resulted in many entities providing financial services that were traditionally provided only by entities regulated and supervised as banks. The Board concluded that this development would make it inappropriate to limit this project to banks and similar financial institutions.

BC7 The Board considered whether entities that undertake specified activities commonly undertaken by banks and other financial institutions, namely deposit-taking, lending and securities activities, face unique risks that would require a standard specific to them. However, the Board decided that the scope of this project should include disclosures about risks arising from financial instruments in all entities for the following reasons:

- (a) disclosures about risks associated with financial instruments are useful to users of the financial statements of all entities.
- (b) the Board found it could not satisfactorily define deposit-taking, lending, and securities activities. In particular, it could not satisfactorily differentiate an entity with securities activities from an entity holding a portfolio of financial assets for investment and liquidity management purposes.
- (c) responses to the Exposure Draft of Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation*, published in June 2002, indicated that IAS 32's risk disclosure requirements, applicable to all entities, could be improved.

- (d) the exclusion of some financial instruments would increase the danger that risk disclosures could be incomplete and possibly misleading. For example, a debt instrument issued by an entity could significantly affect its exposures to liquidity risk, interest rate risk and currency risk even if that instrument is not held as part of deposit-taking, lending and securities activities.
- (e) users of financial statements need to be able to compare similar activities, transactions and events of different entities on a consistent basis. Hence, the disclosure principles that apply to regulated entities should not differ from those that apply to non-regulated, but otherwise similar, entities.

BC8 The Board decided that the scope of the IFRS should be the same as that of IAS 32 with one exception. The Board concluded that the IFRS should not apply to derivatives based on interests in subsidiaries, associates or joint ventures if the derivatives meet the definition of an equity instrument in IAS 32. This is because equity instruments are not remeasured and hence:

- (a) they do not expose the issuer to balance sheet and income statement risk; and
- (b) the disclosures about the significance of financial instruments for financial position and performance are not relevant to equity instruments.

Although these instruments are excluded from the scope of IFRS 7, they are within the scope of IAS 32 for the purpose of determining whether they meet the definition of equity instruments.

Exemptions considered by the Board

Insurers

BC9 The Board considered whether the IFRS should apply to entities that both have financial instruments and issue insurance contracts. The Board did not exempt these entities because financial instruments expose all entities to risks regardless of what other assets and liabilities they have. Accordingly, an entity that both issues insurance contracts and has financial instruments applies IFRS 4 *Insurance Contracts* to its insurance contracts and IFRS 7 to its financial assets and financial liabilities. However, many of the disclosure requirements in IFRS 4 were applications of, or relatively straightforward analogies with, existing requirements in IAS 32. Therefore, the Board also updated the disclosures required by IFRS 4 to make them consistent with IFRS 7, with modifications that reflect the interim nature of IFRS 4.

Small and medium-sized entities

BC10 The Board considered whether it should exempt small and medium-sized entities from the scope of the IFRS. The Board noted that the extent of disclosures required by the IFRS will depend on the extent to which the entity uses financial instruments and the extent to which it has assumed associated risks. The IFRS requires entities with few financial instruments and few risks to give few disclosures. Also, many of the requirements in the IFRS are based on information provided internally to the entity's key management personnel. This helps to avoid unduly onerous requirements that would not be appropriate for smaller entities. Accordingly, the Board decided not to exempt such entities from the scope of IFRS 7. However, it will keep this decision under review in its project on financial reporting for small and medium-sized entities.

Subsidiaries

- BC11 Some respondents to ED 7 stated that there is little public interest in the financial statements of some entities, such as a wholly-owned subsidiary whose parent issues publicly available financial statements. These respondents stated that such subsidiaries should be exempt from some of the requirements of IFRS 7 in their individual financial statements. However, deciding whether such an entity should prepare general purpose financial statements is a matter for the entity and local legislators and regulators. If such an entity prepares financial statements in accordance with IFRSs, users of those statements should receive information of the same quality as users of any general purpose financial statements prepared in accordance with IFRSs. The Board confirmed its view that no exemptions from the general requirements of any Standard should be given for the financial statements of subsidiaries.

Disclosures about the significance of financial instruments for financial position and performance (paragraphs 7-30, B4 and B5)¹

- BC12 The Board relocated disclosures from IAS 32 to IFRS 7, so that all disclosure requirements for financial instruments are in one Standard. Many of the disclosure requirements about the significance of financial instruments for an entity's financial position and performance were previously in IAS 32. For these disclosures, the relevant paragraphs from the Basis for Conclusions on IAS 32 have been incorporated into this Basis for Conclusions. This Basis for Conclusions does not discuss requirements that the Board did not reconsider either in revising IAS 32 in 2003 or in developing IFRS 7.

The principle (paragraph 7)

- BC13 The Board decided that the disclosure requirements of IFRS 7 should result from the explicit disclosure principle in paragraph 7. The Board also decided to specify disclosures to satisfy this principle. In the Board's view, entities could not satisfy the principle in paragraph 7 unless they disclose the information required by paragraphs 8-30.

Balance sheet disclosures (paragraphs 8-19 and B4)²

Categories of financial assets and financial liabilities (paragraph 8)

- BC14 Paragraph 8 requires entities to disclose financial assets and financial liabilities by the measurement categories in ~~IAS 39~~ IFRS 9 *Financial Instruments: Recognition and Measurement*. The Board concluded that ~~the disclosures~~ for each measurement category would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognised.
- BC15 The Board also concluded that separate disclosure of the carrying amounts of financial assets and financial liabilities that are ~~classified as held for trading and those designated upon initial recognition as financial assets and financial liabilities at fair value through profit or loss~~ and those mandatorily measured at fair value is useful because such designation is at the discretion of the entity.

¹ IFRS 9 *Financial Instruments* deleted paragraph B4 of IFRS 7.

² IFRS 9 *Financial Instruments* deleted paragraph B4 of IFRS 7.

Financial assets or financial liabilities at fair value through profit or loss (paragraphs 9-11, B4 and B5)³

- BC16 ~~IAS 39~~ IFRS 9 permits entities to designate a non-derivative financial liability as at fair value through profit or loss, if specified conditions are met. If entities do so, they are required to provide the disclosures in paragraphs 10 and 11. The Board's reasons for these disclosures are set out in the Basis for Conclusions on ~~IAS 39~~ IFRS 9, paragraphs ~~BC87-BC92~~ BCZ5.29-BCZ5.34.
- BC17 The requirements in paragraphs 9, 11 and B5(a) are related to the Amendments to IAS 39 Financial Instruments: Recognition and Measurement—*The Fair Value Option*, issued in June 2005.⁴ The reasons for those requirements are discussed in the Basis for Conclusions on those Amendments.
- BC18 Paragraph 10(a) requires disclosure of the change in fair value of a financial liability designated as at fair value through profit or loss that is attributable to changes in the liability's credit risk. The Board previously considered this disclosure in its deliberations on the fair value measurement of financial liabilities in IAS 39.
- BC19 Although quantifying such changes might be difficult in practice, the Board concluded that disclosure of such information would be useful to users of financial statements and would help alleviate concerns that users may misinterpret the profit or loss effects of changes in credit risk, especially in the absence of disclosures. Therefore, in finalising the revisions to IAS 32 in 2003, it decided to require disclosure of the change in fair value of the financial liability that is not attributable to changes in a benchmark interest rate. The Board believed that this is often a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and would provide users with information with which to understand the profit or loss effect of such a change in credit risk.
- BC20 However, some respondents to ED 7 stated that they did not agree that the IAS 32 disclosure provided a reasonable proxy, except for straightforward debt instruments. In particular, there could be other factors involved in the change in an instrument's fair value unrelated to the benchmark interest rate, such as the effect of an embedded derivative. Respondents also cited difficulties for unit-linked insurance contracts, for which the amount of the liability reflects the performance of a defined pool of assets. The Board noted that the proxy that was developed in IAS 32 assumed that it is not practicable for entities to determine directly the change in fair value arising from changes in credit risk. However, the Board acknowledged and shared these concerns.
- BC21 As a result, the Board amended this requirement to focus directly on the objective of providing information about the effects of changes in credit risk:
- (a) by permitting entities to provide a more faithful representation of the amount of change in fair value that is attributable to changes in credit risk if they could do so. However, such entities are also required to disclose the methods used and provide their justification for concluding that those methods give a more faithful representation than the proxy in paragraph 10(a)(i).
 - (b) by amending the proxy disclosure to be the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk. For example, some entities may be able to identify part of the change in the fair value of the liability as attributable to a change in an index. In these cases, the proxy disclosure would exclude the amount of change attributable to a change in an index. Similarly, excluding the amount attributable to a change in an internal or external investment fund makes the proxy more suitable for unit-linked insurance contracts.

³ IFRS 9 *Financial Instruments* deleted paragraph B4 of IFRS 7.

⁴ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.

BC22 The Board decided that when an entity has designated a financial liability as at fair value through profit or loss, it should disclose the difference between the carrying amount and the amount the entity would contractually be required to pay at maturity to the holders of the liability (see paragraph 10(b)). The fair value may differ significantly from the settlement amount, in particular for financial liabilities with a long duration when an entity has experienced a significant deterioration in creditworthiness since their issue. The Board concluded that knowledge of this difference would be useful to users of financial statements. Also, the settlement amount is important to some financial statement users, particularly creditors.

Reclassification (paragraphs 12 and ~~12AB-12D~~)

BC23 IAS 32 required disclosure of the reason for reclassification of financial assets at cost or amortised cost rather than at fair value. The Board extended this requirement to include disclosure of the reason for reclassifications and of the amount reclassified into and out of each category. As noted in paragraph BC14, the Board regards such information as useful because the categorisation of financial instruments has a significant effect on their measurement.

BC23A In October and November 2008 the Board amended IAS 39⁵ to permit reclassification of particular financial assets in some circumstances. The Board decided to require additional disclosures about the situations in which any such reclassification is made, and the effects on the financial statements. The Board regards such information as useful because the reclassification of a financial asset can have a significant effect on the financial statements.

BC23B The Board issued the requirements relating to the reclassification of financial assets in IFRS 9 *Financial Instruments* and revised accordingly the disclosure requirements relating to the reclassification of financial assets.

BC24 [Deleted]

Offsetting financial assets and financial liabilities

Background

BC24A Following requests from users of financial statements and recommendations from the Financial Stability Board, in June 2010 the IASB and the FASB added a project to their respective agendas to improve and potentially achieve convergence of the requirements for offsetting financial assets and financial liabilities. The different requirements result in a significant difference between amounts presented in statements of financial position prepared in accordance with IFRSs and amounts presented in statements of financial position prepared in accordance with US GAAP, particularly for entities that have large amounts of derivative activities.

BC24B Consequently, in January 2011 the IASB and the FASB published the exposure draft *Offsetting Financial Assets and Financial Liabilities*. The exposure draft proposed common offsetting requirements for IFRSs and US GAAP and proposed disclosures about financial assets and financial liabilities that are subject to rights of set-off and related arrangements.

BC24C Most respondents to the exposure draft supported the boards' efforts towards achieving convergence, but their responses to the proposals varied. Many IFRS preparers agreed with the proposals, stating that the underlying principle and proposed criteria were similar to those in IAS 32 and reflect an entity's credit and liquidity exposure to such instruments. Some US GAAP preparers indicated that offsetting in the statement of financial position in accordance with the proposed criteria provided more relevant information than the current model, except for derivatives and repurchase or reverse repurchase agreements.

⁵ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.

BC24D There was no consensus among users of financial statements regarding if, or when, to present gross or net information in the statement of financial position. However, there was consensus that both gross and net information are useful and necessary for analysing financial statements. Users of financial statements supported achieving convergence of the IFRS and US GAAP requirements, and also supported improving disclosures so that financial statements prepared in accordance with IFRSs and US GAAP would be more comparable. Comparable information is important to investors for calculating their ratios and performing their analyses.

BC24E As a result of the feedback received on the exposure draft, the IASB and the FASB decided to maintain their respective offsetting models. However, the boards noted that requiring common disclosures of gross and net amounts of recognised financial instruments that are (a) set off in the statement of financial position and (b) subject to enforceable master netting arrangements and similar agreements, even if not set off in the statement of financial position, would be helpful for users of financial statements. Accordingly, the boards agreed on common disclosure requirements by amending and finalising the disclosures initially proposed in the exposure draft.

Scope (paragraph 13A)

BC24F The disclosures in the exposure draft would have applied to all recognised financial assets and recognised financial liabilities subject to a right of set-off, and/or for which an entity had either received or pledged cash or other financial instruments as collateral.

BC24G Respondents to the exposure draft noted that paragraphs 14, 15 and 36(b) of IFRS 7 already require disclosures of financial instrument collateral received and pledged and other credit enhancements. US GAAP has similar disclosure requirements. Consequently, if an entity has no financial assets or financial liabilities subject to a right of set-off (other than collateral agreements or credit enhancements), the boards concluded that there would be no incremental value in providing additional disclosure information for such instruments.

BC24H For example, some respondents were concerned that providing disclosure of conditional rights to set off loans and customer deposits at the same financial institution would be a significant operational burden. Such rights are often a result of statute, and entities do not typically manage their credit risk related to such amounts based on these rights of set-off. In addition, entities that have contractual rights to set off customer deposits with loans only in situations such as events of default see these rights as a credit enhancement and not as the primary source of credit mitigation. Respondents argued that the cost of including these amounts in the amended disclosures would outweigh the benefit because users of financial statements did not request information related to these instruments when discussing the offsetting disclosure requirements.

BC24I The boards agreed and decided to limit the scope of the disclosures to all financial instruments that meet the boards' respective offsetting models and recognised financial assets and recognised financial liabilities that are subject to an enforceable master netting arrangement or a similar agreement. The boards specifically excluded loans and customer deposits with the same financial institution from the scope of these requirements (except in the limited cases when the respective offsetting model is satisfied). This reduced scope still responds to the needs of users of financial statements for information about amounts that have been set off in accordance with IFRSs and amounts that have been set off in accordance with US GAAP. The types of instruments that fall within the scope of these disclosures include the instruments that cause significant differences between amounts presented in statements of financial position prepared in accordance with IFRSs and amounts presented in statements of financial position prepared in accordance with US GAAP.

- BC24J If there is an associated collateral agreement for such instruments, an entity would disclose amounts subject to such agreements in order to provide full information about its exposure in the normal course of business, as well as in the events of default and insolvency or bankruptcy.
- BC24K Other respondents requested that the scope of the proposed disclosures be further amended to exclude financial instruments for which the lender has the right to set off the related non-financial collateral in the event of default. Although non-financial collateral agreements may exist for some financial instruments, those preparers do not necessarily manage the credit risk related to such financial instruments on the basis of the non-financial collateral held.
- BC24L The disclosures focus on the effects of recognised financial instruments and financial instrument set-off agreements on an entity's financial position. The boards also noted that a comprehensive reconsideration of credit risk disclosures was not within the scope of this project. They therefore restricted the scope of the disclosures to exclude financial instruments with rights of set-off only for non-financial collateral.
- BC24M A few respondents were concerned that the proposals seem to be designed for financial institutions and would impose requirements on non-financial institutions. They questioned the benefit that such disclosures would provide to investors in non-financial entities.
- BC24N Although the boards acknowledged that financial institutions would be among those most affected, they did not agree that the disclosures are only relevant for financial institutions. Other industries have similar financial instrument activities and use enforceable master netting arrangements and similar agreements to mitigate exposure to credit risks. Consequently, the boards concluded that the required disclosures provide useful information about an entity's arrangements, irrespective of the nature of the entity's business.

Disclosure of quantitative information for recognised financial assets and recognised financial liabilities within the scope of paragraph 13A (paragraph 13C)

- BC24O The boards understood that recognised financial instruments included in the disclosure requirements in paragraph 13C of IFRS 7 may be subject to different measurement requirements. For example, a payable related to a repurchase agreement may be measured at amortised cost, while a derivative asset or derivative liability subject to the same disclosure requirements (for example, in paragraph 13C(a) of IFRS 7) will be measured at fair value. In addition, the fair value amount of any financial instrument collateral received or pledged and subject to paragraph 13C(d)(ii) of IFRS 7 should be included in the disclosures to provide users of financial statements with the best information about an entity's exposure. Consequently, a financial asset or financial liability disclosure table may include financial instruments measured at different amounts. To provide users of financial statements with the information they need to evaluate the amounts disclosed in accordance with paragraph 13C of IFRS 7, the boards decided that an entity should describe any resulting measurement differences in the related disclosures.

Disclosure of the net amounts presented in the statement of financial position (paragraph 13C(c))

- BC24P When providing feedback on the proposals in the exposure draft, users of financial statements emphasised that information in the notes should be clearly reconciled back to the amounts in the statement of financial position. The boards therefore decided that if an entity determines that the aggregation or disaggregation of individual financial statement line item amounts provides more relevant information when

disclosing amounts in accordance with paragraph 13C of IFRS 7, the entity must still reconcile the amounts disclosed in paragraph 13C(c) of IFRS 7 back to the individual line item amounts in the statement of financial position.

Disclosure of the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 13C(b) (paragraph 13C(d))

BC24Q Paragraph 13C(d)(i) of IFRS 7 requires disclosure of amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of IAS 32. This may include current rights of set-off that do not meet the criterion in paragraph 42(b) of IAS 32, or conditional rights of set-off that are enforceable and exercisable only in the event of default, or only in the event of insolvency or bankruptcy of any of the counterparties. Although such rights do not qualify for set-off in accordance with IAS 32, users of financial statements are interested in arrangements that an entity has entered into that mitigate the entity's exposure to such financial instruments in the normal course of business and/or in the events of default and insolvency or bankruptcy.

BC24R Paragraph 13C(d)(ii) of IFRS 7 requires disclosure of amounts of cash and financial instrument collateral (whether recognised or unrecognised) that do not meet the criteria for offsetting in the statement of financial position but that relate to financial instruments within the scope of these disclosure requirements. Depending on the terms of the collateral arrangement, collateral will often reduce an entity's exposure in the events of default and insolvency or bankruptcy of a counterparty to the contract. Collateral received or pledged against financial assets and financial liabilities may often be liquidated immediately upon an event of default. Consequently, the boards concluded that the amounts of collateral that are not set off in the statement of financial position but that are associated with other netting arrangements should be included in the amounts disclosed as required by paragraph 13C(d)(ii) of IFRS 7.

Limits on the amounts disclosed in paragraph 13C(d) (paragraph 13D)

BC24S The boards concluded that an aggregate disclosure of the amount of cash collateral and/or the fair value of collateral in the form of other financial instruments would be misleading when some financial assets and financial liabilities are over-collateralised and others have insufficient collateral. To prevent an entity from inappropriately obscuring under-collateralised financial instruments with others that are over-collateralised, paragraph 13D of IFRS 7 restricts the amounts of cash and/or financial instrument collateral to be disclosed in respect of a recognised financial instrument to more accurately reflect an entity's exposure. However, if rights to collateral can be enforced across financial instruments, such rights can be included in the disclosure provided in accordance with paragraph 13D of IFRS 7. At no point in time should under-collateralisation be obscured.

Disclosure by type of financial instrument or by counterparty

BC24T The exposure draft proposed disclosures by class of financial instrument. An entity would have been required to group financial assets and financial liabilities separately into classes that were appropriate to the nature of the information disclosed, taking into account the characteristics of those financial instruments and the applicable rights of set-off. Many preparers were concerned that the cost of disclosing amounts related to rights of set-off in the events of default and insolvency or bankruptcy by class of financial instrument would outweigh the benefit. They also indicated that they often manage credit exposure by counterparty and not necessarily by class of financial instrument.

BC24U Many users of financial statements indicated that disclosure of recognised amounts subject to enforceable master netting arrangements and similar agreements (including financial collateral) that were not set off in the statement of financial position would be useful irrespective of whether the amounts are disclosed by counterparty or by type or by class of financial instrument, as long as they can reconcile these amounts back to the statement of financial position. In evaluating whether the disclosures should be provided by type or by class of financial instrument or by counterparty, the boards noted that the objective of these disclosures (paragraph 13B of IFRS 7) is that an entity should disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position.

BC24V The boards decided to reduce the burden on preparers by requiring disclosure by type of financial instrument rather than by class. Disclosure by type of financial instrument may (or may not) differ from the class of financial instrument used for other disclosures in IFRS 7, but is appropriate in circumstances where a difference would better achieve the objective of the disclosures required by these amendments. The boards also decided to provide flexibility as to whether the information required by paragraph 13C(c)–(e) of IFRS 7 is presented by type of financial instrument or by counterparty. This would allow preparers to present the disclosures in the same way that they manage their credit exposure.

BC24W The Board also noted that paragraph 31 of IFRS 7 requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. In addition, paragraph 34 of IFRS 7 requires the disclosure of concentrations of risk for each type of risk. Consequently, the Board noted that, irrespective of whether the disclosures were required to be provided by type or by class of financial instrument or by counterparty, entities are already required to disclose information about risks and how they are managed, including information about concentrations of credit risk.

Other considerations

Reconciliation between IFRSs and US GAAP

BC24X Some users of financial statements asked for information to help them reconcile between the amounts set off in accordance with IFRSs and the amounts set off in accordance with US GAAP. The boards recognised that the amounts disclosed in accordance with paragraph 13C(b), (c) and (d) of IFRS 7 will probably be different for financial statements prepared in accordance with IFRSs and those prepared in accordance with US GAAP. However, the amounts disclosed in accordance with paragraph 13C(a) and (e) of IFRS 7 are generally not affected by the offsetting criteria applied in the statement of financial position. These amounts are important for users of financial statements to understand the effects of netting arrangements on an entity's financial position in the normal course of business and in the events of default and insolvency or bankruptcy.

BC24Y Consequently, while the amended disclosure requirements do not directly reconcile the IFRS and US GAAP amounts, they provide both gross and net information on a comparable basis. The boards considered that requiring a full reconciliation between IFRSs and US GAAP was unnecessary, particularly given the relative costs and benefits. Such reconciliation would have required preparers to apply two sets of accounting requirements and to track any changes to the related accounting standards and to contracts in the related jurisdictions.

Tabular information

BC24Z The disclosures require amounts to be presented in a tabular format (ie a table) unless another format is more appropriate. The boards believe that a tabular format best conveys an overall understanding of the effect of any rights of set-off and other related arrangements on an entity's financial position and improves the transparency of such information.

Transition and effective date

BC24AA The boards identified two transition approaches in the exposure draft—prospective and retrospective.

BC24AB Prospective transition is generally appropriate only in situations where it is not practicable to apply a standard to all prior periods. The boards did not believe that this was the case with the proposed disclosure requirements. Retrospective transition would require an entity to apply the new requirements to all periods presented. This would maximise consistency of financial information between periods. Retrospective transition would enable analysis and understanding of comparative accounting information among entities. In addition, the scope of the disclosures was reduced and the disclosures amended to require less detailed information than originally proposed, which would make them less burdensome for preparers to apply retrospectively.

BC24AC The exposure draft did not propose an effective date, but instead asked respondents for information about the time and effort that would be involved in implementing the proposed requirements. The boards indicated that they would use such feedback, as well as the responses in their *Request for Views on Effective Dates and Transition Methods*, and the timing of other planned accounting and reporting standards, to determine an appropriate effective date for the proposals in the exposure draft.

BC24AD Some respondents suggested that the offsetting proposals should have the same effective date as the other components of the IASB's project to replace IAS 39 with IFRS 9 *Financial Instruments*. If an earlier date was required, it was suggested that application should be restricted only to the accounting period being presented, rather than providing comparative information, because of the potential burden of applying the proposed disclosure requirements.

BC24AE At the time the amended disclosure requirements were issued (December 2011), IFRS 9 was not yet mandatorily effective. However, the Board did not believe that the IFRS 9 project would change the offsetting disclosures. Aligning the effective date of these amendments with the effective date of the financial instruments project could result in postponing the effective date of the common disclosure requirements, which would mean a delay in providing users of financial statements the information that they need. For users of financial statements to benefit from the increased comparability, and because the offsetting and IFRS 9 projects are independent of one another, the boards decided that common disclosures should be effective as early as possible.

BC24AF In addition, the boards did not think that a long transition period was needed, because the amended disclosures had a reduced scope and less detailed information than originally proposed in the exposure draft and were related to the presentation of instruments that entities have already recognised and measured. The boards therefore decided that the effective date for the amended disclosures should be for annual periods beginning on or after 1 January 2013, and interim periods within those annual periods.

BC24AG As described in greater detail in other sections of this Basis for Conclusions, the disclosures required by paragraphs 13B–13E of IFRS 7 are a result of requests from users of financial statements for information to enable them to compare statements of financial position prepared in accordance with IFRSs with statements of financial

position prepared in accordance with US GAAP, particularly for entities that have large amounts of derivative activities.

BC24AH The information required in paragraphs 13B–13E of IFRS 7 will enable users of financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with an entity's recognised financial assets and recognised financial liabilities, on the entity's financial position for financial statements presented in accordance with IFRSs and those presented in accordance with US GAAP.

BC24AI The Board noted that paragraph 10(f) of IAS 1 *Presentation of Financial Statements* requires an entity to provide a statement of financial position as at 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. In the case of *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7), because the change relates only to disclosures and there is no associated change in accounting policy, or a resulting restatement or reclassification, it was noted that paragraph 10(f) of IAS 1 does not apply for these amendments to IFRS 7.

Cost-benefit considerations

BC24AJ Before issuing an IFRS or an amendment to an IFRS, the Board seeks to ensure that it will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. As described in greater detail in other sections of this Basis for Conclusions on *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7), the Board considered that there is significant benefit to market participants in providing these disclosures. The disclosures address a significant difference between the amounts presented in statements of financial position prepared in accordance with IFRSs and amounts presented in statements of financial position prepared in accordance with US GAAP, particularly for entities that have large amounts of derivative activities. The disclosures therefore make the amounts presented in accordance with both sets of standards more comparable.

BC24AK During redeliberations, the Board considered feedback related to the costs of providing the disclosures proposed in the exposure draft. As described in greater detail in other sections of this Basis for Conclusions, the Board decided to limit the scope of the disclosures because these changes would reduce the cost to preparers while still providing the information that users of financial statements had requested.

BC24AL On the basis of the considerations described in the Basis for Conclusions on these amendments, and summarised in paragraphs BC24AJ and BC24AK, the Board concluded that the benefits of *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7) outweigh the costs to preparers of applying these amendments.

Collateral (paragraphs 14 and 15)

BC25 Paragraph 15 requires disclosures about collateral that the entity holds if it is permitted to sell or repledge the collateral in the absence of default by the owner. Some respondents to ED 7 argued for an exemption from this disclosure if it is impracticable to obtain the fair value of the collateral held. However, the Board concluded that it is reasonable to expect an entity to know the fair value of collateral that it holds and can sell even if there is no default.

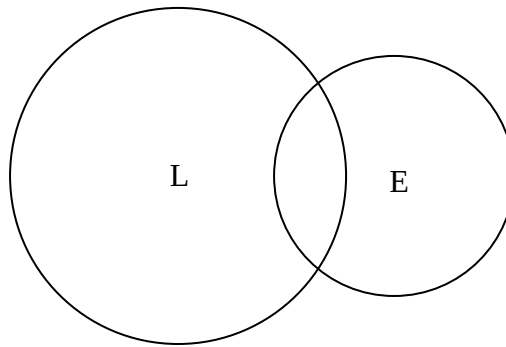
Allowance account for credit losses (paragraph 16)⁶

- BC26 When a separate account is used to record impairment losses (such as an allowance account or similar account used to record a collective impairment of assets), paragraph 16 requires a reconciliation of that account to be disclosed. The Board was informed that analysts and other users find this information useful in assessing the adequacy of the allowance for impairment losses for such entities and when comparing one entity with another. However, the Board decided not to specify the components of the reconciliation. This allows entities flexibility in determining the most appropriate format for their needs.
- BC27 Respondents to ED 7 asked the Board to require entities to provide equivalent information if they do not use an allowance account. The Board decided not to add this disclosure in finalising the IFRS. It concluded that, for virtually all entities, IAS 39's requirement to consider impairment on a group basis would necessitate the use of an allowance or similar account. The accounting policy disclosures required by paragraph B5(d) also include information about the use of direct adjustments to carrying amounts of financial assets.

Compound financial instruments with multiple embedded derivatives (paragraph 17)

- BC28 IAS 32 requires the separation of the liability and equity components of a compound financial instrument. The Board notes that this is more complicated for compound financial instruments with multiple embedded derivative features whose values are interdependent (for example, a convertible debt instrument that gives the issuer a right to call the instrument back from the holder, or the holder a right to put the instrument back to the issuer) than for those without such features. If the embedded equity and non-equity derivative features are interdependent, the sum of the separately determined values of the liability and equity components will not equal the value of the compound financial instrument as a whole.
- BC29 For example, the values of an embedded call option feature and an equity conversion option feature in a callable convertible debt instrument depend in part on each other if the holder's equity conversion option is extinguished when the entity exercises the call option or vice versa. The following diagram illustrates the joint value arising from the interaction between a call option and an equity conversion option in a callable convertible bond. Circle L represents the value of the liability component, ie the value of the straight debt and the embedded call option on the straight debt, and Circle E represents the value of the equity component, ie the equity conversion option on the straight debt. The total area of the two circles represents the value of the callable convertible bond. The difference between the value of the callable convertible bond as a whole and the sum of the separately determined values for the liability and equity components is the joint value attributable to the interdependence between the call option feature and the equity conversion feature. It is represented by the intersection between the two circles.

⁶ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.



- BC30 Under the approach in IAS 32, the joint value attributable to the interdependence between multiple embedded derivative features is included in the liability component. A numerical example is set out as Illustrative Example 10 accompanying IAS 32.
- BC31 Even though this approach is consistent with the definition of equity as a residual interest, the Board recognises that the allocation of the joint value to either the liability component or the equity component is arbitrary because it is, by its nature, joint. Therefore, the Board concluded that it is important to disclose the existence of issued compound financial instruments with multiple embedded derivative features that have interdependent values. Such disclosure highlights the effect of multiple embedded derivative features on the amounts recognised as liabilities and equity.

Defaults and breaches (paragraphs 18 and 19)

- BC32 Paragraphs 18 and 19 require disclosures about defaults and breaches of loans payable and other loan agreements. The Board concluded that such disclosures provide relevant information about the entity's creditworthiness and its prospects of obtaining future loans.

Income statement and equity (paragraph 20)

Items of income, expenses, gains or losses (paragraph 20(a))

- BC33 Paragraph 20(a) requires disclosure of income statement gains and losses by the measurement classifications in ~~IAS 39~~ IFRS 9 (which complement the balance sheet disclosure requirement described in paragraph BC14). The Board concluded that the disclosure is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in ~~IAS 39~~ IFRS 9.
- BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities ~~held for trading measured at fair value through profit or loss~~ and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities ~~held for trading measured at fair value through profit or loss~~ include interest and dividend income (see Appendix B, paragraph B5(e)).

Fee income and expense (paragraph 20(c))

- BC35 Paragraph 20(c) requires disclosure of fee income and expense (other than amounts included in determining the effective interest rate) arising from financial assets or financial liabilities and from trust and other fiduciary activities that result in the entity holding or placing assets on behalf of individuals, trusts, retirement benefit plans, and other institutions. This information indicates the level of such activities and helps users to estimate possible future income of the entity.

Other disclosures—hedge accounting

BC35A The Board divided its project to replace IAS 39 into three phases. As the Board completed each phase, it deleted the relevant portions in IAS 39 and replaced it with chapters in IFRS 9. The third phase of the project to replace IAS 39 related to hedge accounting. As a consequence of the decisions the Board made when it replaced the hedge accounting guidance in IAS 39, the Board also considered changes to the disclosure requirements related to hedge accounting contained in IFRS 7.

BC35B During its deliberations, the Board engaged in outreach activities with users of financial statements. This outreach included soliciting views on presentation and disclosures. The Board used the responses received from those outreach activities to develop the proposed hedge accounting disclosures.

BC35C The Board was told that many users did not find the hedge accounting disclosures in financial statements helpful. Many also think that the hedge accounting disclosures that were originally in IFRS 7 did not provide transparency on an entity's hedging activities.

BC35D To provide relevant information that enhances the transparency on an entity's hedging activities, the Board proposes hedge accounting disclosures that meet particular objectives. Clear disclosure objectives allow an entity to apply its judgement when it provides information that is useful and relevant to users of financial statements.

BC35E The following sub-sections set out the Board's considerations regarding the proposed hedge accounting disclosures.

General considerations

Scope of the hedge accounting disclosures

BC35F An entity might enter into a transaction to manage an exposure to a particular risk that might not qualify for hedge accounting (for various reasons), for example, an item that is not eligible to be designated as a hedged item or hedging instrument. Information on such transactions might enable users to understand why an entity has entered into a transaction and how it manages the particular risk, even though those transactions do not qualify for hedge accounting.

BC35G However, the Board thought that mandating such disclosures would require it to determine the part of an entity's risk management that was relevant for the purpose of this disclosure and then define that part to make the disclosure requirement operational. The Board did not believe that this would be feasible as part of its hedge accounting project as it requires a much wider scope because the disclosures would not depend on the accounting treatment.

BC35H Furthermore, users of financial statements can often obtain information on an entity's hedging activities from information in management reports and sources outside the financial reporting context. That often gives a reasonable overview of why hedge accounting might be difficult to achieve. Consequently, the Board decided not to propose in its 2010 Exposure Draft *Hedge Accounting* (the '2010 Hedge Accounting Exposure Draft') disclosures about hedging when hedge accounting does not apply.

BC35I Most respondents to the 2010 Hedge Accounting Exposure Draft agreed with the Board's proposed scope for hedge accounting disclosures (ie to provide information about risk exposures that an entity hedges and for which hedge accounting is applied). However, some did raise concerns about the potential lack of information that will be available to users of financial statements about those risk exposures an entity hedges but for which hedge accounting is not applied.

BC35J The Board noted that IFRS 7 requires entities to provide qualitative and quantitative disclosure about the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period and how those risks are being managed. The Board believes that, as part of these disclosures, entities would provide information for users of financial statements to understand how it manages risk exposures for which hedge accounting is not applied.

BC35K Consequently, the Board decided to retain the scope of the hedge accounting disclosures as proposed in the 2010 Hedge Accounting Exposure Draft, that is, to provide information to users of financial statements on exposures that an entity hedges and for which hedge accounting is applied.

Location of disclosures

BC35L The Board decided that all hedge accounting disclosures should be presented in one location within an entity's financial statements. However, if such information is already presented elsewhere the Board decided that, in order to avoid duplication, an entity should be allowed to incorporate that information by cross-reference, which is similar to the approach used by IFRS 7 for some disclosures that can be incorporated by reference. The Board thinks that the information will be more transparent and easier to understand if it is presented in one location within the entity's financial statements.

Disclosures by risk category

BC35M The Board noted that recognition and measurement requirements allow for only a partial reflection of the economic hedging activities in the financial statements, which results in a limitation of an entity's reporting of its hedging activities. Hence, the Board considered that the transparency of an entity's hedging activities could be enhanced by an approach that considers:

- (a) information that provides a clear picture of those risk management activities of an entity that are captured by hedge accounting (this information is not necessarily provided in the primary financial statements); and
- (b) information that is included in the primary financial statements.

BC35N To provide information that is useful to users of financial statements, there should be a clear link between the hedge accounting information that is outside the primary financial statements and the hedge accounting within those. To provide such a link, the Board decided that an entity should provide hedge accounting disclosures by risk category. Consequently, an entity should disclose by risk category:

- (a) information that is not included in the primary financial statements (see paragraphs BC35P–BC35BB); and
- (b) information that is included in the primary financial statements (see paragraphs BC35CC–BC35SS).

BC35O The Board decided not to prescribe the risk categories by which the disclosures need to be disaggregated. In the Board's view an entity should apply judgement and categorise risks on the basis of how it manages its risks through hedging. For example, an entity manages its floating interest rate risk using interest rate swaps (to change it to a fixed interest rate) for some hedging relationships (cash flow hedges), while it also uses cross-currency interest rate swaps to manage both the floating interest rate and foreign exchange risk of other hedging relationships (cash flow hedges). Consequently, the entity would have one risk category for floating interest rate risk and another risk category for foreign exchange risk combined with floating interest rate risk. However, an entity should apply its risk categories consistently throughout all the proposed hedge accounting disclosures.

The risk management strategy

BC35P Users of financial statements need to understand how an entity's risk management strategy is applied. Understanding an entity's risk management strategy for each risk helps users to understand the accounting information disclosed.

BC35Q Consequently, in its 2010 Hedge Accounting Exposure Draft, the Board proposed that an entity should provide an explanation of its risk management strategy for each category of risk.

BC35R Most respondents to the 2010 Hedge Accounting Exposure Draft agreed with this proposal. However, some raised concerns that the 2010 Hedge Accounting Exposure Draft was not clear enough on how much detail should be provided by entities to comply with the disclosure requirement.

BC35S The Board noted that an entity will identify and ultimately describe their risk management strategies based on how it manages risk. Because entities manage risk in different ways, the Board did not think that users of financial statements would necessarily understand an entity's risk management strategy if it required a specific list of information to be disclosed. Instead, the Board decided to add additional guidance on the type of information that should be included in a risk management description.

The amount, timing and uncertainty of future cash flows

BC35T The Board decided that, in order to meet the objectives of hedge accounting disclosures, an entity would have to provide sufficient quantitative information to help users of financial statements understand how its risk management strategy for each particular risk affects the amount, timing and uncertainty of future cash flows. In this context, risk exposure refers only to risks that the entity has decided to hedge and for which hedge accounting is applied.

BC35U Consequently, in its 2010 Hedge Accounting Exposure Draft, the Board proposed that an entity should provide:

- (a) quantitative information on the risk exposure that the entity manages and the extent to which the entity hedges that exposure; and
- (b) a breakdown of that information for each future period that a hedging relationship (which exists at the reporting date) covers.

BC35V The Board also proposed that an entity should disclose information about the sources of hedge ineffectiveness of hedging relationships for each particular risk category. In the Board's view this would assist users in identifying the reasons for hedge ineffectiveness that is recognised in profit or loss. It would also help users to determine how hedging relationships will affect profit or loss.

BC35W Most respondents disagreed with the Board's proposal to require entities to disclose information on the risk exposure and the hedged rate. They commented that this would result in the disclosure of commercially sensitive information (ie the risk exposure and the hedged rate). They believed that those who do not elect to apply hedge accounting would potentially have an unfair advantage because although they do not have to disclose anything, they could nonetheless gain insight into their competitor's hedge positions. Commercial sensitivity was also of concern to those entities whose competitors are not listed companies or who do not report under IFRSs.

BC35X The Board noted that the proposal in the 2010 Hedge Accounting Exposure Draft focused on the hedged risk (ie the hedged item). Consequently, it would result in disclosures about forward looking information and the rates at which future

transactions are hedged. The Board acknowledged that this would potentially provide competitors with insight into an entity's costing structure. Consequently, the Board decided not to require information to be disclosed about the total risk exposure because of the potential forward looking nature of this information. The Board also decided to change the focus of the proposed disclosure from the hedged item to the hedging instrument. In other words, the disclosure would require information on some of the terms and conditions of the hedging instrument to be provided. The Board believes that this information will still be relevant and useful for users of financial statements in inferring the exposure that an entity is exposed to and what the effects will be on future cash flows as a result of how the entity manages the particular risk.

BC35Y The Board also discussed situations in which an entity uses a 'dynamic' hedging process, ie a situation in which entities assess their overall exposure to a particular risk and then designate hedging relationships for constantly evolving exposures that require frequent discontinuations and restarts of hedging relationships. This is particularly the case for hedges of open portfolios. The Board noted that, because the general hedge accounting model allows hedge accounting for hedges of groups and net positions in relation to closed portfolios, entities need to use a 'dynamic' hedging process for an open portfolio. This means that entities designate hedging relationships for an open portfolio as if it were a closed portfolio for a short period and at the end of that period look at the open portfolio as the next closed portfolio for another short period. The dynamic nature of this process involves frequent discontinuations and restarts of hedging relationships.

BC35Z The Board considered that, in those circumstances, providing information about the terms and conditions of the hedging instruments would not be useful given that the hedging instruments are part of a particular hedging relationship for only a short period at a time and are then designated into a new hedging relationship or left undesignated. In contrast, the disclosure requirement related to the terms and conditions of the hedging instrument was designed to provide information for situations in which an entity hedges a risk that remains broadly the same over the entire hedged period. Consequently, the Board decided to exempt entities from the requirement to disclose the terms and conditions of the hedging instruments in situations in which they use a 'dynamic' hedging process that involves frequent discontinuations and restarts of hedging relationships.

BC35A The Board was of the view that it was more important for users to understand why entities use hedge accounting in the context of 'dynamic' hedging processes than to provide users with information about the terms and conditions of a hedging instrument that is part of a hedging relationship for only a short period at a time (and the designation of which changes frequently). Consequently, the Board decided that, in such circumstances, an entity should expand its discussion of the risk management strategy by providing the following information about how the entity uses hedge accounting to reflect its risk management strategy:

- (a) information about what the ultimate risk management strategy is (for the dynamic hedging process);
- (b) a description of how it reflects its risk management strategy by using hedge accounting and designating the particular hedging relationships; and
- (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic hedging process.

BC35BB The Board also noted that, because the designated hedging relationships change frequently, the specific relationships at the reporting date might not be representative of the normal volumes during the period. The Board therefore decided to require entities to disclose when the volumes at the reporting date are unrepresentative of normal volumes during the period (similar to the disclosure requirement on sensitivity analyses for market risk in paragraph 42).

BC35CCOne function of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures should therefore increase the transparency of how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the entity's statement of profit or loss and other comprehensive income and statement of financial position.

The effects of hedge accounting on financial position and performance

BC35DDTo provide information on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the Board proposed disclosures that should be presented in a tabular format that separates the information by risk category and by type of hedge. Providing disclosures in a tabular format allows users to identify clearly the relevant numbers and their effects on the entity's statement of profit or loss and other comprehensive income and statement of financial position.

BC35EEDuring the Board's initial outreach, users said that they do not analyse an entity's hedging activities by type of hedging relationship (for example, a cash flow hedge or a fair value hedge). They said that it is more important to understand the risks that the entity manages and the results after hedging. However, to provide information effectively on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (for example, cash flow hedge accounting or fair value hedge accounting). The Board believed that if the proposed table is prepared by risk category and by type of hedge, the table would provide sufficient links between the accounting information and the risk management information.

BC35FFThe Board did not propose prescribing levels of aggregation or disaggregation for the information that should be disclosed in a tabular format. An entity should apply judgement when it determines the appropriate level of aggregation or disaggregation. However, the Board proposed that an entity should consider other disclosure requirements in IFRS 7 when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to take amounts that are disclosed and measured at fair value and make comparisons between the fair value disclosures and the proposed hedge accounting disclosures.

BC35GGCash flow hedge accounting requires an entity to defer gains or losses on the hedging instrument in other comprehensive income. The deferred amounts are reflected in the statement of changes in equity in the cash flow hedge reserve. IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. In conformity with its objectives for hedge accounting disclosures, the Board proposed that the reconciliation required by IAS 1 should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of profit or loss and other comprehensive income. The Board also proposed that the reconciliation should be by type of risk. The Board considered that such a disclosure would allow users of financial statements to evaluate the effects of hedge accounting on equity and the statement of profit or loss and other comprehensive income.

BC35HHMany respondents to the 2010 Hedge Accounting Exposure Draft agreed with the Board's proposal to explain the effects of hedge accounting disclosures using a tabular disclosure format. However, some respondents raised concerns that the proposal seems too prescriptive. Some also commented that they did not think that the tabular disclosure, as proposed, provided a clear enough link between hedged items and hedging instruments for the purpose of explaining hedge ineffectiveness. A few respondents also commented that the disclosures did not allow them to differentiate

between financial instruments that have been designated as hedging instruments and those that have not. These respondents believe that it is helpful to understand the purpose and effect of financial instruments if their designation is made clear through disclosures.

BC35II The Board thinks that providing a tabular disclosure format separated by type of hedge (ie fair value hedges or cash flow hedge), risk category and by risk management strategy provides a sufficient link between the accounting information and the risk management information.

BC35JJ The Board did not propose any more specific format other than requiring information to be disclosed in a tabular format. The Board thought that entities should have the freedom to present the disclosures that require a tabular format however they feel is best in order to provide users with the most useful information.

BC35KK While the 2010 Hedge Accounting Exposure Draft was open for public comment, the Board issued IFRS 13 *Fair Value Measurement*. As a consequence of issuing that IFRS, the Board moved the fair value disclosures in IFRS 7 to IFRS 13. To improve the usefulness of the hedge accounting disclosures, the Board decided to require entities to use the same level of aggregation or disaggregation it used for other IFRS 7 or IFRS 13 disclosures related to the same underlying information.

BC35LL In its redeliberations of the 2010 Hedge Accounting Exposure Draft, the Board also considered a disclosure that would allow understanding how the hedge ineffectiveness that is recognised in the statement of comprehensive income relates to the changes in the values of the hedging instruments and the hedged items. The Board decided to require disclosure of the change in fair value of the hedging instruments and the change in the value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of comprehensive income. Those are the changes in value during the period (after taking into account the effect of the 'lower of' test for cash flow hedges and hedges of a net investment in a foreign operation). This means that the difference between the amount included in the table for hedged items and the amount included in the table for hedging instruments equals the hedge ineffectiveness recognised in the statement of comprehensive income.

BC35MM The Board also did not think that it was necessary to provide a specific disclosure that indicates which financial instruments have been designated as hedging instruments and which have not. The Board thought that such a disclosure would provide potentially misleading information to users of financial statements. This is because users of financial statements might think that all financial instruments not designated as hedging instruments might be held for speculative purposes. This is not necessarily the case. Entities might hold financial instruments for hedging purposes but may decide not to elect hedge accounting. In addition to this, the Board thought that, because entities need to provide the information that requires a tabular format based on the same level of aggregation or disaggregation as in IFRS 13, users of financial statements should be able to identify the financial instruments not designated as hedging instruments by simply comparing the disclosures with each other. In addition, users should be able to understand how an entity manages the risks it is exposed to as a result of financial instruments using the disclosure requirements in IFRS 7 that are not related to the hedge accounting disclosures.

Time value of options accumulated through other comprehensive income

BC35NN The Board proposed accounting requirements that involve other comprehensive income for the time value of an option when an entity elects to separate the time value of the option and designate (as the hedging instrument) only its intrinsic value. Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.

BC35OOThe Board noted that IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. Consequently, as a result of IAS 1, an entity would disclose the amounts in relation to the time value of options that would be accumulated in other comprehensive income and the movements in that balance.

BC35PPHowever, in its 2010 Hedge Accounting Exposure Draft, the Board proposed that an entity should differentiate between transaction related hedged items and time-period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.

BC35QQMost respondents agreed with the Board's proposal and consequently, the Board decided to retain the proposal from its 2010 Hedge Accounting Exposure Draft. However, as a consequence of the Board's decision to also allow an alternative accounting treatment for forward elements and foreign currency basis spreads, the Board also required that for the purpose of the IAS 1, amounts recognised in accumulated other comprehensive income that relate to forward elements and foreign currency basis spreads should be reconciled separately from amounts in relation to time value of options.

Hedging credit risk using credit derivatives

BC35RRFor situations in which entities hedge credit risk using credit derivatives the Board decided to mitigate accounting mismatches in relation to credit derivatives accounted for at fair value through profit or loss by also using fair value through profit or loss accounting for the hedged credit exposure. Consequently, the Board also considered disclosures to provide transparency when entities apply that accounting.

BC35SSThe Board considered that the following information would be useful for understanding the accounting in such situations:

- (a) a reconciliation of amounts at the beginning and end of the period for the nominal amount and for the fair value of the credit derivatives;
- (b) the gain or loss recognised in profit or loss as a result of changing the accounting for a credit exposure to fair value through profit or loss; and
- (c) when an entity discontinues fair value through profit or loss accounting for credit exposures, the fair value that becomes the new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

Other disclosures—fair value (paragraphs 25-30)⁷

BC36 Many entities use fair value information internally in determining their overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial statements because, in many circumstances, it reflects the judgement of the financial markets about the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of why they are held and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. The Board decided that

⁷ IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value and for disclosing information about fair value measurements. As a consequence paragraphs 27-27B of IFRS 7 have been deleted.

when an entity does not measure a financial asset or financial liability in its balance sheet at fair value, it should provide fair value information through supplementary disclosures to assist users to compare entities on a consistent basis.

- BC37 Disclosure of fair value is not required for investments in unquoted equity instruments⁸ and derivatives linked to such equity instruments if their fair value cannot be measured reliably.⁹ Similarly, IFRS 4 does not specify the accounting required for contracts containing a discretionary participation feature pending phase II of the Board's project on insurance contracts. Accordingly, disclosure of fair value is not required for contracts containing a discretionary participation feature, if the fair value of that feature cannot be measured reliably. For all other financial assets and financial liabilities, it is reasonable to expect that fair value can be determined with sufficient reliability within constraints of timeliness and cost. Therefore, the Board concluded that there should be no other exception from the requirement to disclose fair value information for financial assets or financial liabilities.
- BC38 To provide users of financial statements with a sense of the potential variability of fair value estimates, the Board decided that information about the use of valuation techniques should be disclosed, in particular the sensitivities of fair value estimates to the main valuation assumptions.¹⁰ In forming this conclusion, the Board considered the view that disclosure of sensitivities could be difficult, particularly when there are many assumptions to which the disclosure would apply and these assumptions are interdependent. However, the Board noted that a detailed quantitative disclosure of sensitivity to all assumptions is not required (only those that could result in a significantly different estimate of fair value are required) and that the disclosure does not require the entity to reflect interdependencies between assumptions when making the disclosure. Additionally, the Board considered whether this disclosure might imply that a fair value established by a valuation technique is less reliable than one established by other means. However, the Board noted that fair values estimated by valuation techniques are more subjective than those established from an observable market price, and concluded that users need information to help them assess the extent of this subjectivity.
- BC39 Paragraph 28 requires disclosure about the difference that arises if the transaction price differs from the fair value of a financial instrument that is determined in accordance with paragraph ~~AG76 of IAS 39~~B5.4.8 of IFRS 9.¹¹ Those disclosures relate to matters addressed in the December 2004 amendment to IAS 39 *Transition and Initial Recognition of Financial Assets and Financial Liabilities*. That amendment does not specify how entities should account for those initial differences in subsequent periods. The disclosures required by paragraph 28 inform users about the amount of gain or loss that will be recognised in profit or loss in future periods. The Board noted that the information required to provide these disclosures would be readily available to the entities affected.
- BC39A Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) issued by the US Financial Accounting Standards Board requires disclosures that are based on a three-level fair value hierarchy for the inputs used in valuation techniques to measure fair value. The Board was asked by some users of financial statements to include similar disclosure requirements in IFRS 7 to provide more information about the relative reliability of the inputs to fair value measurements. The Board concluded that such a hierarchy would improve comparability between

⁸ IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 and IFRS 9 refer to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

⁹ IFRS 9 changed the measurement requirements for investments in equity instruments.

¹⁰ IFRS 13, issued in May 2011, resulted in paragraph 27B(c) of IFRS 7 being deleted.

¹¹ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence of issuing that IFRS, paragraph B5.4.8 of IFRS 9 was deleted. However, in 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraph B5.4.8 of IFRS 9 now contains requirements related to amortised cost measurement.

entities about the effects of fair value measurements as well as increase the convergence of IFRSs and US generally accepted accounting principles (GAAP). Therefore, the Board decided to require disclosures for financial instruments on the basis of a fair value hierarchy.¹²

BC39B Because its own fair value measurement project was not yet completed, the Board decided not to propose a fair value hierarchy for measurement, but only for disclosures. The fair value hierarchy for disclosures is the same as that in SFAS 157 but uses IFRS language pending completion of the fair value measurement project. Although the implicit fair value hierarchy for measurement in ~~IAS 39~~ IFRS 9 is different from the fair value hierarchy in SFAS 157, the Board recognised the importance of using a three-level hierarchy for disclosures that is the same as that in SFAS 157.¹³

BC39C The Board noted the following three-level measurement hierarchy implicit in ~~IAS 39~~ IFRS 9:

- (a) financial instruments quoted in an active market;
- (b) financial instruments whose fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets; and
- (c) financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data.

BC39D For example, the Board acknowledged that some financial instruments that, for measurement purposes, are considered to have an active market in accordance with paragraphs ~~AG71-AG73 of IAS 39~~ B5.4.3-B5.4.5 of IFRS 9 might be in Level 2 for disclosure purposes. Also, the application of paragraph ~~AG76A of IAS 39~~ B5.4.9 of IFRS 9 might result in no gain or loss being recognised on the initial recognition of a financial instrument that is in Level 2 for disclosure purposes.¹⁴

BC39E The introduction of the fair value disclosure hierarchy does not affect any measurement or recognition requirements of other ~~standards~~ IFRSs. In particular, the Board noted that the recognition of gains or losses at inception of a financial instrument (as required by paragraph ~~AG76 of IAS 39~~ B5.4.8 of IFRS 9¹⁵) would not change as a result of the fair value disclosure hierarchy.

BC39F The Board decided to require additional disclosures for instruments with fair value measurements that are in Level 3 of the fair value hierarchy.¹⁶ These disclosures

¹² IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value and for the related disclosures.

¹³ ~~IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value and for the related disclosures. That hierarchy is identical to the hierarchy in Topic 820 Fair Value Measurement in the FASB Accounting Standards Codification®, which codified SFAS 157.~~

¹⁴ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a result consequence of issuing that IFRS, paragraphs ~~AG71-AG73 and paragraph AG76A of IAS 39 have been deleted. In addition, the requirements in paragraph AG76A have been relocated to paragraph AG76(b).~~ B5.4.3-B5.4.5 of IFRS 9 were deleted and paragraph B5.4.9 of IFRS 9 was relocated to paragraphs B5.1.2A and B5.2.2A. However, in 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraphs B5.4.3-B5.4.5 and paragraph B5.4.9 of IFRS 9 now contain requirements related to amortised cost measurement.

¹⁵ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence of issuing that IFRS, paragraph B5.4.8 of IFRS 9 was deleted. However, in 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraph B5.4.8 of IFRS 9 now contains requirements related to amortised cost measurement.

¹⁶ IFRS 13, issued in May 2011, requires disclosures about fair value measurements. As a consequence paragraphs 27-27B of IFRS 7 have been deleted.

inform users of financial statements about the effects of those fair value measurements that use the most subjective inputs.

BC39G After reviewing comments received on the exposure draft, the Board decided not to require disclosure by level of the fair value hierarchy for financial instruments that are not measured at fair value in the statement of financial position. The Board noted that paragraphs 25 and 27 of IFRS 7, which require the disclosure of the fair value of each class of assets and liabilities in a way that permits it to be compared with its carrying amount, and the methods and assumptions applied in determining fair values, were retained.¹⁷

Disclosures about the nature and extent of risks arising from financial instruments (paragraphs 31-42 and B6-B28)

BC40 The Board was informed that users of financial statements value information about the risks arising from financial instruments, such as credit risk, liquidity risk and market risk, to which entities are exposed, and the techniques used to identify, measure, monitor and control those risks. Therefore, the Board decided to require disclosure of this information. The Board also decided to balance two objectives:

- (a) consistent requirements should apply to all entities so that users receive comparable information about the risks to which entities are exposed.
- (b) the disclosures provided should depend on the extent of an entity's use of financial instruments and the extent to which it assumes associated risks. Entities with many financial instruments and related risks should provide more disclosure to communicate those risks to users of financial statements. Conversely, entities with few financial instruments and related risks may provide less extensive disclosure.

BC41 The Board decided to balance these two objectives by developing an IFRS that sets out principles and minimum requirements applicable to all entities, supported by guidance on implementing the IFRS. The requirements in paragraphs 33-42 combine qualitative disclosures of the entity's exposure to risks arising from financial instruments, and the way in which management views and manages these risks, with quantitative disclosures about material risks arising from financial instruments. The extent of disclosure depends on the extent of the entity's exposure to risks arising from financial instruments. The guidance on implementing the IFRS illustrates how an entity might apply the IFRS. This guidance is consistent with the disclosure requirements for banks developed by the Basel Committee (known as Pillar 3), so that banks can prepare, and users receive, a single co-ordinated set of disclosures about financial risk.

BC42 The Board noted that because entities view and manage risk in different ways, disclosures based on how an entity manages risk are unlikely to be comparable between entities. In addition, for an entity that undertakes limited management of risks arising from financial instruments, such disclosures would convey little or no information about the risks the entity has assumed. To overcome these limitations, the Board decided to specify disclosures about risk exposures applicable to all entities. These disclosures provide a common benchmark for financial statement users when comparing risk exposures across different entities and are expected to be relatively easy for entities to prepare. Entities with more developed risk management systems would provide more detailed information.

¹⁷ IFRS 13, issued in May 2011, resulted in paragraph 27 of IFRS 7 being deleted.

Interaction between qualitative and quantitative disclosures (paragraph 32A)

BC42A In *Improvements to IFRSs* issued in May 2010, the Board addressed a perceived lack of clarity in the intended interaction between the qualitative and quantitative disclosures of the nature and extent of risks arising from financial instruments. The Board emphasised the interaction between qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments. This enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The Board concluded that an explicit emphasis on the interaction between qualitative and quantitative disclosures will contribute to disclosure of information in a way that better enables users to evaluate an entity's exposure.

Location of disclosures of risks arising from financial instruments (paragraph B6)

BC43 Many respondents to ED 7 argued that disclosures about risks in paragraphs 31-42 should not be part of the financial statements for the following reasons:

- (a) the information would be difficult and costly to audit.
- (b) the information is different from information generally included in financial statements because it is subjective, forward-looking and based on management's judgement. Thus, the information does not meet the criteria of comparability, faithful representation and completeness.
- (c) inclusion of such information in a management commentary section outside the financial statements would be consistent with practice in other jurisdictions, including the US. Having this information in the financial statements would put IFRS preparers at a disadvantage relative to their US peers.

BC44 Respondents raised concerns that the disclosure of sensitivity analysis in particular should not be part of the financial statements. Respondents stated that sensitivity analysis cannot be prepared with the degree of reliability expected of information in the financial statements, and that the subjectivity in the sensitivity analysis and the hypothetical alternative values could undermine the credibility of the fair values recognised in the financial statements.

BC45 The Board considered whether the disclosures should be part of the information provided by management outside the financial statements. The Board noted that respondents generally regarded the disclosures proposed in ED 7 as useful, even if they did not agree that they should be located in the financial statements. The Board's view is that financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial instruments. Hence, it concluded that such disclosures should be part of the financial statements. The Board rejected the argument that increased transparency puts an entity at a disadvantage; greater certainty on the part of investors can provide a significant advantage by lowering the entity's cost of capital.

BC46 The Board also noted that some entities might prefer to present the information required by the IFRS together with material such as a management commentary or risk report that is not part of the financial statements. Some entities might be required by regulatory authorities to provide in a separate report information similar to that required by the IFRS. Accordingly, the Board decided these disclosures should be given in the financial statements or incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms as the financial statements and at the same time.

Quantitative disclosures (paragraphs 34-42 and B7-B28)

Information based on how the entity manages risk (paragraphs 34 and B7)

BC47 The Board concluded that disclosures about an entity's exposure to risks arising from financial instruments should be required, and should be based on how the entity views and manages its risks, ie using the information provided to key management personnel (for example, its board of directors or chief executive officer). This approach:

- (a) provides a useful insight into how the entity views and manages risk;
- (b) results in information that has more predictive value than information based on assumptions and methods that management does not use, for instance, in considering the entity's ability to react to adverse situations;
- (c) is more effective in adapting to changes in risk measurement and management techniques and developments in the external environment;
- (d) has practical advantages for preparers of financial statements, because it allows them to use the data they use in managing risk; and
- (e) is consistent with the approach used in IAS 14 *Segment Reporting*.¹⁸

BC47A In *Improvements to IFRSs* issued in May 2010, the Board removed the reference to materiality from paragraph 34(b) of IFRS 7. The Board noted that the reference could imply that disclosures in IFRS 7 are required even if those disclosures are not material, which was not the Board's intention.

Information on averages

BC48 The Board considered whether it should require quantitative information about average risk exposures during the period. It noted that information about averages is more informative if the risk exposure at the reporting date is not typical of the exposure during the period. However, information about averages is also more onerous to prepare. On balance, the Board decided to require disclosure of the exposures at the reporting date in all cases and to require additional information only if the information provided at the reporting date is unrepresentative of the entity's exposure to risk during the period.

Credit risk (paragraphs 36-38, B9 and B10)

Disclosure objectives

BC48A In developing the impairment disclosure requirements in this IFRS, the Board sought to supplement the existing disclosures to meet the additional information needs of users of financial statements that will arise specifically from an impairment model based on expected credit losses. When relevant, the Board has considered the comments received on the disclosure requirements proposed in the original Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the '2009 Impairment Exposure Draft') and the Board-only appendix to the Supplementary Document *Financial Instruments: Impairment*.

BC48B During the development of the expected credit loss requirements, the Board acknowledged that any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgement and the quality of the information used.

¹⁸ In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*.

BC48C However, the Board believes that this level of judgement is necessary given the differences in how entities approach credit risk management. The Board considered that information is useful and relevant when it enables users of financial statements to predict the likely amounts, timing and uncertainty of future cash flows. Accordingly, the Board identified three objectives for the disclosure requirements and this IFRS requires both qualitative and quantitative disclosures to assist users of financial statements to understand and identify:

- (a) an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses;
- (b) the amounts in the financial statements that arise from expected credit losses that are measured in accordance with IFRS 9, including the changes in the estimate of expected credit losses and the reasons for the changes; and
- (c) an entity's credit risk profile (ie the credit risk inherent in an entity's financial instruments), including significant credit concentrations at the reporting date.

Credit risk management practices

BC48D Requiring entities to estimate expected credit losses will increase the significance of forecasts and the use of an entity's judgement. In addition, IFRS 9 requires entities to incorporate new types of information into the measurement of expected credit losses as compared to IAS 39. In the Board's view it is helpful for users of financial statements to understand the information entities use to estimate expected credit losses.

BC48E When developing the proposals in the 2013 Exposure Draft *Financial Instruments: Expected Credit Losses* (the '2013 Impairment Exposure Draft') the Board noted that disclosures about the methods, assumptions and information used to estimate expected credit losses have been a core part of the disclosure package since the 2009 Impairment Exposure Draft, and are important for understanding how an entity applies the expected credit loss requirements. However, the Board acknowledges that different entities will use different information and techniques for assessing whether they should recognise lifetime expected credit losses. The information and techniques that an entity uses will depend on the nature of its financial instruments and other factors.

BC48F The 2013 Impairment Exposure Draft acknowledged and permitted this. The Board considered that to understand how an entity has applied the proposed expected credit loss requirements, the following information would be relevant and useful:

- (a) how significant increases in credit risk are assessed and identified;
- (b) how default is defined and the reasons for selecting that definition;
- (c) how an entity assesses that financial assets are credit-impaired; and
- (d) the write-off policy applied.

BC48G Respondents to the 2013 Impairment Exposure Draft supported the disclosure of that qualitative information, with a few respondents requesting the disclosure of more qualitative information about the modification of financial instruments and how an entity has incorporated macroeconomic information in its estimates of expected credit losses.

BC48H As noted in paragraph BC5.252 of IFRS 9, the notion of default is fundamental to the application of the impairment model, particularly because it affects the population that is subject to the 12-month expected credit loss measure. The Board noted during

redeliberations on the 2013 Impairment Exposure Draft that default can be interpreted in various ways, ranging from broad judgemental definitions based on qualitative factors to narrower non-judgemental definitions focusing only on non-payment. The appropriate definition also depends on the nature of the financial instrument in question. Given the various interpretations of default, the Board decided to require the disclosure of an entity's definition of default and the reasons for its selection.

BC48I The Board considered that an explanation of how forward-looking information, including macroeconomic information, has been incorporated in the measurement of expected credit losses would provide relevant and useful information, given the requirement in IFRS 9 to consider all reasonable and supportable information that is available without undue cost and effort when determining whether there has been a significant increase in credit risk since initial recognition. The Board also considered that an explanation of how an entity has applied the requirements in paragraph 5.5.12 of IFRS 9 for the modification of contractual cash flows of financial assets, including how an entity determines whether the credit risk of modified financial assets has improved so that is not considered to be significantly increased compared to initial recognition, would enhance the understanding of how an entity manages credit risk through modifications and restructurings.

BC48J The 2013 Impairment Exposure Draft proposed that an entity should disclose the nominal amount of financial assets that have been written off but that are still subject to enforcement activity. This was included because feedback from users of financial statements indicated users would like to understand the extent to which recoveries of written off assets are still possible. The Board acknowledged this desire, however it determined that the disclosure of the aggregate amount of financial assets that have been written off but that remain subject to enforcement activity would not provide the most relevant information for this purpose. For example, the nominal amount could be very high (particularly as time passes, if the asset legally continues to accrue interest) even though the prospect of recovering any amounts outstanding might be extremely low. In addition, the Board received feedback from preparers that tracking these amounts for an extended period would be operationally burdensome. As a result, the Board decided to modify the disclosure and require that entities disclose the amount of financial assets that have been written off during the period, while narrative information is provided about financial assets that have previously been written off but that are still subject to enforcement activity.

BC48K The Board also proposed narrative disclosures to complement the quantitative disclosures. In the Board's view, users of financial statements would further benefit from a qualitative explanation of changes in estimates of expected credit losses. Estimates of expected credit losses may change, for example, because of changes in the volume of financial instruments, changes in overall market conditions or as a result of a significant event (for example, a sovereign debt crisis, weather-related events or other disasters). The disclosures should therefore include a qualitative narrative describing how significant events have affected the entity's estimate of expected credit losses.

Financial instruments evaluated on an individual basis

BC48L Previously paragraph 37(b) of IFRS 7 required an analysis of financial instruments that are individually determined to be credit-impaired as at the end of the reporting period, including an analysis of the factors that the entity considered when determining that those financial instruments are credit-impaired. Many entities already disclose the loan balance and loss allowance amount for both collectively and individually assessed credit-impaired loans. Consequently, the 2013 Impairment Exposure Draft proposed amendments to those requirements to limit them to financial instruments that an entity assesses individually for recognition of lifetime expected credit losses.

BC48M During outreach activities, users of financial statements noted that it is important for them to understand which financial instruments an entity assesses on an individual

basis, especially when that individual assessment is because of an increase in credit risk and closer management of the instrument. While these financial instruments may not have experienced an increase in credit risk greater than those evaluated on a group basis, the Board concluded that this distinction helps users of financial statements to understand how an entity is monitoring and managing credit risk, so it is useful even when the difference is not attributable to differences in credit risk.

BC48N However, several respondents to the 2013 Impairment Exposure Draft argued that a disclosure of the gross carrying amount of financial assets (and the amount recognised as a loss allowance for loan commitments and financial guarantee contracts) that are assessed on an individual basis is not relevant in an impairment model based on expected credit losses. These respondents argued that unlike in IAS 39, the loss allowance does not result from objective evidence of impairment on an individual asset.

BC48O The Board noted that conceptually, an assessment on an individual or collective basis should render the same result. However, as noted in paragraph B5.5.2 of IFRS 9, an entity may not have access to reasonable and supportable information that enables it to identify significant increases in credit on an individual basis prior to financial assets becoming past due. Furthermore, an entity may only be able to incorporate forward-looking information in its estimates of expected credit losses on a collective basis. The Board therefore decided instead to require the disclosure of information about how an entity has grouped financial instruments if they are assessed or measured on a collective basis.

Amounts arising from expected credit losses

Reconciliation of the gross carrying amount and loss allowance

BC48P The Supplementary Document proposed the mandatory use of a loss allowance account for credit losses, with separate disclosure of reconciliations for the two groups of financial assets that an entity would distinguish for the purpose of determining the loss allowance (ie assets in the 'good book' and assets in the 'bad book'). Almost all respondents supported the mandatory use of a loss allowance account. Consequently, the 2013 Impairment Exposure Draft retained that proposal.

BC48Q The 2013 Impairment Exposure Draft also retained the proposal in the Supplementary Document to show a reconciliation of the gross carrying amount of financial asset separately for each of the groups of financial assets that an entity would distinguish between for the purpose of determining the loss allowance (ie 12-month expected credit losses and lifetime expected credit losses) and each of the related loss allowances. Respondents (including preparers) generally supported disclosing a reconciliation (ie flow information) of changes in the loss allowance and stated that it was operational and useful. However, similar to the feedback received on the Supplementary Document, respondents to the 2013 Impairment Exposure Draft commented that showing separate reconciliations of the gross carrying amount of financial assets was onerous, especially when they were required to disclose the effect of the change of financial assets between those with loss allowances measured at amounts equal to 12-month and lifetime expected credit losses. They noted that when loss allowances are determined on a collective (ie portfolio) basis, an entity does not allocate loss allowances to individual financial assets. Preparers also stated that the costs associated with the disclosure, and any disclosure about flow information, would be substantial. In order to provide this information for open portfolios, an entity would be required to track changes in the credit risk of individual financial instruments and calculate the change in the loss allowance that results from new loans, derecognised assets, changes between 12-month and lifetime loss allowances and changes in estimates of credit losses. They noted that this would be contrary to the requirement in IFRS 9 which requires lifetime expected credit losses to be recognised even if a significant increase in credit risk cannot be identified on an individual financial instrument basis.

BC48R During outreach, users of financial statements have consistently and strongly expressed the view that the change in the gross carrying amount of financial assets and the effect on the loss allowance are critical elements in understanding the credit quality of an entity's financial instruments and its credit risk management practices. They held the view that the reconciliation of the gross carrying amount of financial instruments would greatly enhance transparency of an entity's financial asset portfolio. While these disclosures would require systems changes and the cost of providing the information would be high, the Board noted that such reconciliations provide key information about movements between 12-month and lifetime loss allowances and about the causes of changes in expected credit losses and about the effect of changes in volume and credit quality.

BC48S The Board therefore decided to retain the requirement to provide a reconciliation of the changes in the loss allowance. However, in the light of the feedback about the operational burden of reconciling the changes in the gross carrying amount of financial assets, the Board clarified that the objective of that reconciliation is to provide information about the key drivers for changes in the gross carrying amount to the extent that it contributes to changes in the loss allowance during the period. Examples of such key drivers for change could include new originations and purchases, deterioration of existing financial instruments resulting in the loss allowance changing to lifetime expected credit losses and financial assets being written off during the period. The Board also acknowledged that although the most relevant and useful information will be provided by disclosing the gross movements between loss allowance measurement categories, in some circumstances, or for some types of financial assets, information will be more useful if the movements are disclosed on a net basis (for example trade receivables accounted for in accordance with the general approach in IFRS 9).

Loan commitments and financial guarantee contracts

BC48T The 2013 Impairment Exposure Draft proposed that expected credit losses on loan commitments and financial guarantee contracts should be recognised as a provision in the statement of financial position. The Board noted that it would be inappropriate to recognise a loss allowance for such financial instruments because there is no corresponding asset with which to present that loss allowance.

BC48U The Board noted feedback on the 2013 Impairment Exposure Draft that indicated that for most loan commitments and financial guarantee contracts, entities estimate expected credit losses on an instrument (facility) level and are therefore not able to distinguish the expected credit losses related to the drawn component (the financial asset) and the undrawn component (the loan commitment). Consequently, it would not seem appropriate to attempt to allocate expected credit losses to each of these components for the purposes of presenting the loss allowance on each component separately and any allocation would probably be arbitrary.

BC48V The Board therefore decided that the loss allowance on a loan commitment or a financial guarantee contract should be presented together with the loss allowance for expected credit losses on the associated financial asset, if an entity cannot separately identify the expected credit losses related to the separate components. To the extent that the amount of expected credit losses on a loan commitment or a financial guarantee contract exceeds the carrying amount of the associated financial asset recognised in the statement of financial position, the remaining balance should be presented as a provision.

Purchased or originated credit-impaired assets

BC48W The Board sought to enhance the comparability of financial assets that are credit-impaired on initial recognition with those that are not. Consequently, the Board decided that an entity should disclose the undiscounted expected credit losses that are implicit in the pricing at initial recognition for purchased or originated credit-impaired financial assets. Users of financial statements have indicated that such

a disclosure would be helpful in alleviating some of the complexity in this area of accounting and would allow them to see the possible contractual cash flows that an entity could collect if there was a favourable change in expectations of credit losses for such assets.

Modifications

BC48X Throughout the Impairment project, users of financial statements have noted that an area in which current disclosures and information is insufficient is that of restructurings and modifications. Particularly during the global financial crisis, users have expressed frustration at the difficulty of understanding the extent of restructuring activity that entities are undertaking in respect of their financial assets.

BC48Y The 2013 Impairment Exposure Draft proposed to require the disclosure of the gross carrying amount of financial assets that have been modified during their life at a time when the loss allowance was measured at lifetime expected credit losses and for which the measurement of the loss allowance had subsequently changed back to 12-month expected credit losses. This proposed requirement resulted from users of financial statements requesting information to enable them to understand the amount of financial assets that have been modified and that have subsequently improved in credit quality. During redeliberations the Board noted operational concerns raised in feedback from preparers about the need to meet such a requirement by tracking individual financial assets, particularly even long after such assets have returned to a performing status and are no longer closely monitored for credit risk management purposes. The Board noted that the usefulness of the information would decrease over time as an increasing number of assets are required to be included in the disclosure. The Board therefore decided to limit the requirement to financial assets that have previously been modified at a time when the loss allowance was measured at lifetime expected credit losses and for which the loss allowance has changed back to 12-month expected credit losses during the reporting period.

BC48Z During redeliberations of the 2013 Impairment Exposure Draft the Board received feedback that the modification guidance in IFRS 9 should be limited to modifications of credit-impaired assets or modifications undertaken for credit risk management purposes. The Board rejected these views and confirmed that the scope of this guidance applies to all modifications of contractual cash flows, regardless of the reason for the modification. In making this decision, the Board noted that an amortised cost carrying amount equates to the present value of the expected contractual cash flows, discounted at the effective interest rate. Consequently, the carrying amount should reflect changes in those contractual cash flows, irrespective of the reason for the modification occurring. In addition, it was noted that any change in contractual terms will have an impact on credit risk, even if small. Furthermore, the Board noted that it has been told previously that identifying those modifications that have been performed for credit risk management (ie non-commercial) purposes is operationally challenging. Consequently, the disclosures in paragraph 35K of IFRS 7 apply to all modifications of contractual cash flows.

Collateral and credit risk mitigation disclosures

BC48AACollateral and other credit risk mitigants are important factors in an entity's estimate of expected credit losses. For instance, an entity with more heavily collateralised loans will, all other things being equal, record a smaller loss allowance for credit losses than an entity with unsecured loans. The previous requirements of paragraph 36(b) of IFRS 7 required the disclosure of information similar to that proposed in the 2013 Impairment Exposure Draft. However, the Board received feedback that these collateral disclosures were too onerous and costly to prepare, and therefore proposed to limit the quantitative collateral disclosure requirements to those financial instruments that become credit-impaired subsequent to initial recognition.

BC48BBFeedback on the 2013 Impairment Exposure Draft indicated that respondents remained concerned about the disclosure of quantitative information about collateral for financial instruments that become credit-impaired subsequent to initial recognition. The Board maintained the view that information about the financial effect of collateral is useful. However, the Board noted that it did not intend to require providing information about the fair value of collateral. In addition, the Board decided that qualitative information should be disclosed about how collateral and other credit enhancements have been incorporated into the measurement of expected credit losses on all financial instruments.

Credit risk exposure

BC48CCBecause the recognition of lifetime expected credit losses is based on a significant increase in credit risk since initial recognition, there could be a wide range of initial credit risk for which 12-month expected credit losses is recognised (for example, loans that are originated with a high credit risk but have not increased in credit risk subsequently would have a loss allowance based on 12-month expected credit losses as would high quality loans that have not significantly increased in credit risk since initial recognition). To provide users of financial statements with information about the changes in the loss allowance and the entity's exposure to credit risk on financial instruments, the 2013 Impairment Exposure Draft proposed a disaggregation of the carrying amounts of financial instruments into credit risk categories, for both 12-month and lifetime expected credit losses.

BC48DDDDisaggregating by credit risk shows the entity's exposure to credit risk and its credit risk profile at a given point in time (ie the reporting date). Users of financial statements indicated that they were concerned about the relative nature of the disclosure that is based on the range of credit risk relevant to the entity's portfolio and that it would lack comparability as a result (ie a high risk for one entity may only be a medium risk for another). Furthermore, without vintage information, a user would not be able to determine whether changes in the risk profile are a result of changes in the credit risk of existing financial instruments or a result of the credit risk of new instruments recognised during the period. However, they believed that risk disaggregation would still provide insight into an entity's exposure to credit risk and were therefore in favour of including it in the notes to the financial statements. The Board required the disclosure because changes in risk will affect the measurement of expected credit losses and it would therefore provide users of financial statements with information about the drivers of the change in the measurement. The Board also noted that this disclosure, particularly when considered together with the reconciliation of the gross carrying amount and loss allowance, provides relevant and useful information about credit risk migration and changes in overall credit risk over time.

BC48EEThe Board considered adding language to the proposed disclosure that would have required an entity to reconcile this disclosure to internal credit rating grades. However, responses to the Supplementary Document considered this internal risk-rating information to be proprietary and therefore objected to this level of specificity. Consequently, the Board decided not to propose this reconciliation.

BC48FFSome respondents to the 2013 Impairment Exposure Draft also commented that the disclosure was incompatible with the credit risk management practices for some asset classes and for non-financial entities, and noted that the disclosure should be aligned with an entity's internal credit risk approach. In the light of this feedback the Board decided to remove the requirement to provide a disaggregation across a minimum of three credit risk rating grades, and instead require that the disaggregation to be aligned with how credit risk is managed internally. The Board additionally decided to permit the use of an ageing analysis for financial assets for which delinquency information is the only borrower-specific information available to assess significant increases in credit risk.

Simplified approach for trade receivables, contract assets and lease receivables

BC48GG This IFRS includes exceptions to the general disclosures for trade receivables, contract assets and lease receivables when an entity applies the simplified approach. The Board noted that these exemptions provide relief that is consistent with the intention to simplify the application of the impairment model for these categories of financial assets to alleviate some of the practical concerns of tracking changes in credit risk.

Maximum exposure to credit risk (paragraphs 36(a), B9 and B10)

BC49 Paragraph 36(a) requires disclosure of an entity's maximum exposure to credit risk at the reporting date. Some respondents to ED 7 stated that these disclosures would not provide useful information when there are no identified problems in a loan portfolio, and it is not likely that collateral would be called on. However, the Board disagreed because it believes that such information:

- (a) provides users of financial statements with a consistent measure of an entity's exposure to credit risk; and
- (b) takes into account the possibility that the maximum exposure to loss may differ from the amount recognised in the balance sheet.

BC49A In *Improvements to IFRSs* issued in May 2010, the Board enhanced consistency within IFRS 7 by clarifying that the disclosure requirement in paragraph 36(a) applies only to financial assets whose carrying amounts do not show the reporting entity's maximum exposure to credit risk. Such an approach is consistent with the approach taken in paragraph 29(a), which states that disclosure of fair value is not required when the carrying amount is a reasonable approximation of fair value. Moreover, the Board concluded that the requirement might be duplicative for assets that are presented in the statement of financial position because the carrying amount of these assets often represents the maximum exposure to credit risk. In the Board's view, the disclosure requirement should focus on the entity's exposure to credit risk that is not already reflected in the statement of financial position.

BC50 Some respondents to ED 7 questioned whether the maximum exposure to credit risk for a derivative contract is its carrying amount because fair value does not always reflect potential future exposure to credit risk (see paragraph B10(b)). However, the Board noted that paragraph 36(a) requires disclosure of the amount that best represents the maximum exposure to credit risk *at the reporting date*, which is the carrying amount.

Collateral held as security and other credit enhancements (paragraphs 36(b) and 37(c))

BC51 ED 7 proposed that, unless impracticable, the entity should disclose the fair value of collateral held as security and other credit enhancements, to provide information about the loss the entity might incur in the event of default. However, many respondents to ED 7 disagreed with this proposal on cost/benefit grounds. Respondents indicated that fair value information might not be available for:

- (a) small entities and entities other than banks, which may find it onerous to acquire information about collateral;
- (b) banks that collect precise information on the value of collateral only on origination, for loans whose payments are made on time and in full (for example a mortgage portfolio secured by properties, for which valuations are not kept up to date on an asset-by-asset basis);

- (c) particular types of collateral, such as a floating charge on all the assets of an entity; and
- (d) insurers that hold collateral for which fair value information is not readily available.

BC52 The Board also noted respondents' concerns that an aggregate disclosure of the fair value of collateral held would be misleading when some loans in a portfolio are over-collateralised, and other loans have insufficient collateral. In these circumstances, netting the fair value of the two types of collateral would under-report the amount of credit risk. The Board agreed with respondents that the information useful to users is not the total amount of credit exposure less the total amount of collateral, but rather is the amount of credit exposure that is left after available collateral is taken into account.

BC53 Therefore, the Board decided not to require disclosure of the fair value of collateral held, but to require disclosure of only a description of collateral held as security and other credit enhancements. The Board noted that such disclosure does not require an entity to establish fair values for all its collateral (in particular when the entity has determined that the fair value of some collateral exceeds the carrying amount of the loan) and, thus, would be less onerous for entities to provide than fair values.

Credit quality of financial assets that are neither past due nor impaired (paragraph 36(c))¹⁹

BC54 The Board noted that information about credit quality gives a greater insight into the credit risk of assets and helps users assess whether such assets are more or less likely to become impaired in the future. Because this information will vary between entities, the Board decided not to specify a particular method for giving this information, but rather to allow each entity to devise a method that is appropriate to its circumstances.

Financial assets with renegotiated terms (paragraph 36(d))

BC54A In *Improvements to IFRSs* issued in May 2010, the Board addressed a practical concern relating to the disclosure requirements for renegotiated financial assets. The Board deleted the requirement in paragraph 36(d) to disclose the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated. The Board considered the difficulty in identifying financial assets whose terms have been renegotiated to avoid becoming past due or impaired (rather than for other commercial reasons). The Board noted that the original requirement was unclear about whether the requirement applies only to financial assets that were renegotiated in the current reporting period or whether past negotiations of those assets should be considered. Moreover, the Board was informed that commercial terms of loans are often renegotiated regularly for reasons that are not related to impairment. In practice it is difficult, especially for a large portfolio of loans, to ascertain which loans were renegotiated to avoid becoming past due or impaired.

Financial assets that are either past due or impaired (paragraph 37)²⁰

BC55 The Board decided to require separate disclosure of financial assets that are past due or impaired to provide users with information about financial assets with the greatest credit risk (paragraph 37). This includes:

- (a) an analysis of the age of financial assets, including trade receivables, that are past due at the reporting date, but not impaired (paragraph 37(a)). This information provides users with information about those financial assets that are more likely to become impaired and helps users to estimate the level of future impairment losses.

¹⁹ IFRS 9 *Financial Instruments* deleted paragraph 36(c) of IFRS 7.

²⁰ IFRS 9 *Financial Instruments* deleted paragraph 37 of IFRS 7.

- (b) an analysis of financial assets that are individually determined to be impaired at the reporting date, including the factors the entity considered in determining that the financial assets are impaired (paragraph 37(b)). The Board concluded that an analysis of impaired financial assets by factors other than age (eg nature of the counterparty, or geographical analysis of impaired assets) would be useful because it helps users to understand why the impairment occurred.

BC55A In *Improvements to IFRSs* issued in May 2010, the Board addressed a concern that the disclosure of the fair value of collateral was potentially misleading. Within a class of assets some might be over-collateralised while others might be under-collateralised. Hence, aggregate disclosure of the fair value might be misleading. Therefore, the Board removed from paragraph 37(c) the requirement to disclose the fair value of collateral and other credit enhancements. However, the Board believes that information on the financial effect of such assets is useful to users. Hence, the Board included in paragraph 36(b) a requirement to disclose a description of collateral held as security and of other credit enhancements and to disclose their financial effect.

Collateral and other credit enhancements obtained (paragraph 38)

BC56 Paragraph 38 requires the entity to disclose the nature and carrying amount of assets obtained by taking possession of collateral held as security or calling on other credit enhancements and its policy for disposing of such assets. The Board concluded that this information is useful because it provides information about the frequency of such activities and the entity's ability to obtain and realise the value of the collateral. ED 7 had proposed that the entity should disclose the fair value of the assets obtained less the cost of selling them, rather than the carrying amount. The Board noted that this amount might be more relevant in the case of collateral obtained that is expected to be sold. However, it also noted that such an amount would be included in the impairment calculation that is reflected in the amount recognised in the balance sheet and the purpose of the disclosure is to indicate the amount recognised in the balance sheet for such assets.

BC56A In *Improvements to IFRSs* issued in May 2010, the Board enhanced consistency within IFRS 7 by clarifying that paragraph 38 requires entities to disclose the amount of foreclosed collateral held at the reporting date. This is consistent with the objective in IFRS 7 to disclose information that enables users to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Liquidity risk (paragraphs 34(a), 39, B10A and B11A-B11F)

BC57 The Board decided to require disclosure of a maturity analysis for financial liabilities showing the remaining earliest contractual maturities (paragraph 39(a) and paragraphs B11-B16 of Appendix B²¹). Liquidity risk, ie the risk that the entity will encounter difficulty in meeting commitments associated with financial liabilities, arises because of the possibility (which may often be remote) that the entity could be required to pay its liabilities earlier than expected. The Board decided to require disclosure based on the earliest contractual maturity date because this disclosure shows a worst case scenario.

BC58 Some respondents expressed concerns that such a contractual maturity analysis does not reveal the expected maturity of liabilities, which, for some entities—eg banks with many demand deposits—may be very different. They suggested that a contractual maturity analysis alone does not provide information about the conditions expected in normal circumstances or how the entity manages deviations from expected maturity. Therefore, the Board decided to require a description of how the entity manages the liquidity risk portrayed by the contractual maturity analysis.

²¹ Amendments to IFRS 7 issued in March 2009 amended paragraph 39 and paragraphs B11-B16. The paragraph references in paragraph BC57 have not been amended as a result of these amendments.

BC58A In March 2009 the Board amended the disclosure requirements on the nature and extent of liquidity risk by:

- (a) amending the definition of liquidity risk to clarify that paragraph 39 applies only to financial liabilities that will result in the outflow of cash or another financial asset. This clarifies that the disclosure requirements would not apply to financial liabilities that will be settled in the entity's own equity instruments and to liabilities within the scope of IFRS 7 that are settled with non-financial assets.
- (b) emphasising that an entity must provide summary quantitative data about its exposure to liquidity risk based on information provided internally to key management personnel of the entity as required by paragraph 34(a). This reinforces the principles of IFRS 7.
- (c) amending the requirement in paragraph 39 to disclose a contractual maturity analysis.

BC58B The requirements in paragraph 39(a) and (b) relate to minimum benchmark disclosures as set out in paragraph 34(b) and are expected to be relatively easy to apply. However, the Board noted that the requirement to provide disclosures based on the remaining contractual maturities was difficult to apply for some derivative financial liabilities and did not always result in information that reflects how many entities manage liquidity risk for such instruments. Hence, for some circumstances the Board eliminated the previous requirement to disclose contractual maturity information for derivative financial liabilities. However, the Board retained minimum contractual maturity disclosures for non-derivative financial liabilities (including issued financial guarantee contracts within the scope of the IFRS) and for some derivative financial liabilities.

BC58C The Board noted that for non-derivative financial liabilities (including issued financial guarantee contracts within the scope of the IFRS) and some derivative financial liabilities, contractual maturities are essential for an understanding of the timing of cash flows associated with the liabilities. Therefore, this information is useful to users of financial statements. The Board concluded that disclosures based on the remaining contractual maturities of these financial liabilities should continue to be required.

BC58D The Board also emphasised the existing requirement to disclose a maturity analysis for financial assets held for managing liquidity risk, if that information is required to enable users of its financial statements to evaluate the nature and extent of liquidity risk. The Board also emphasised that an entity must explain the relationship between qualitative and quantitative disclosures about liquidity risk so that users of financial statements can evaluate the nature and extent of liquidity risk.

Market risk (paragraphs 40-42 and B17-B28)

BC59 The Board decided to require disclosure of a sensitivity analysis for each type of market risk (paragraph 40) because:

- (a) users have consistently emphasised the fundamental importance of sensitivity analysis;
- (b) a sensitivity analysis can be disclosed for all types of market risk and by all entities, and is relatively easy to understand and calculate; and
- (c) it is suitable for all entities—including non-financial entities—that have financial instruments. It is supported by disclosures of how the entity manages the risk. Thus, it is a simpler and more suitable disclosure than other approaches, including the disclosures of terms and conditions and the gap analysis of interest rate risk previously required by IAS 32.

The Board noted that information provided by a simple sensitivity analysis would not be comparable across entities. This is because the methodologies used to prepare the sensitivity analysis and the resulting disclosures would vary according to the nature of the entity and the complexity of its risk management systems.

- BC60 The Board acknowledged that a simple sensitivity analysis that shows a change in only one variable has limitations. For example, the analysis may not reveal non-linearities in sensitivities or the effects of interdependencies between variables. The Board decided to meet the first concern by requiring additional disclosure when the sensitivity analysis is unrepresentative of a risk inherent in a financial instrument (paragraph 42). The Board noted that it could meet the second concern by requiring a more complex sensitivity analysis that takes into account the interdependencies between risks. Although more informative, such an analysis is also more complex and costly to prepare. Accordingly, the Board decided not to require such an analysis, but to permit its disclosure as an alternative to the minimum requirement when it is used by management to manage risk.
- BC61 Respondents to ED 7 noted that a value-at-risk amount would not show the effect on profit or loss or equity. However, entities that manage on the basis of value at risk would not want to prepare a separate sensitivity analysis solely for the purpose of this disclosure. The Board's objective was to require disclosures about sensitivity, not to mandate a particular form of sensitivity disclosure. Therefore, the Board decided not to require disclosure of the effects on profit or loss and equity if an alternative disclosure of sensitivity is made.
- BC62 Respondents to ED 7 requested the Board to provide more guidance and clarification about the sensitivity analysis, in particular:
- (a) what is a reasonably possible change in the relevant risk variable?
 - (b) what is the appropriate level of aggregation in the disclosures?
 - (c) what methodology should be used in preparing the sensitivity analysis?
- BC63 The Board concluded that it would not be possible to provide comprehensive guidance on the methodology to be used in preparing the sensitivity analysis. The Board noted that more comparable information would be obtained if it imposed specific requirements about the inputs, process and methodology of the analysis, for example disclosure of the effects of a parallel shift of the yield curve by 100 basis points. However, the Board decided against such a specific requirement because a reasonably possible change in a relevant risk variable (such as interest rates) in one economic environment may not be reasonably possible in another (such as an economy with higher inflation). Moreover, the effect of a reasonably possible change will vary depending on the entity's risk exposures. As a result, entities are required to judge what those reasonably possible changes are.
- BC64 However, the Board decided that it would provide high level application guidance about how the entity should assess what is a reasonably possible change and on the appropriate level of aggregation in the disclosures. In response to comments received on ED 7, the Board also decided to clarify that:
- (a) an entity should not aggregate information about material exposures to risk from significantly different economic environments. However, if it has exposure to only one type of market risk in only one economic environment, it might not show disaggregated information.
 - (b) the sensitivity analysis does not require entities to determine what the profit or loss for the period would have been had the relevant risk variable been different. The sensitivity analysis shows the effect on current period profit or loss and equity if a reasonably possible change in the relevant risk variable

had been applied to the risk exposures in existence at the balance sheet date.

- (c) a reasonably possible change is judged relative to the economic environments in which the entity operates, and does not include remote or “worst case” scenarios or “stress tests”.
- (d) entities are required to disclose only the effects of the changes at the limits of the reasonably possible range of the relevant risk variable, rather than all reasonably possible changes.
- (e) the time frame for which entities should make an assessment about what is reasonably possible is the period until the entity next presents these disclosures, usually its next annual reporting period.

The Board also decided to add a simple example of what a sensitivity analysis might look like.

Operational risk

BC65 The Board discussed whether it should require disclosure of information about operational risk. However, the Board noted that the definition and measurement of operational risk are in their infancy and are not necessarily related to financial instruments. It also decided that such disclosures would be more appropriately located outside the financial statements. Therefore, the Board decided to defer this issue to its research project on management commentary.

Disclosures relating to transfers of financial assets

Background

BC65A In March 2009, in conjunction with the Memorandum of Understanding between the IASB and the US Financial Accounting Standards Board (FASB) to improve and achieve convergence of IFRS and US standards for derecognition, the IASB published an exposure draft to replace the derecognition requirements of IAS 39²² and to improve the disclosure requirements in IFRS 7 relating to the transfer of financial assets and liabilities. In response to feedback received on the exposure draft the IASB developed more fully the alternative model described in the exposure draft and the boards discussed the alternative model.

BC65B In May 2010 the boards reconsidered their strategies and plans for the derecognition project in the light of:

- (a) their joint discussions of the alternative derecognition model described in the exposure draft;
- (b) the June 2009 amendments to the US GAAP derecognition guidance by the FASB, which reduced the differences between IFRSs and US GAAP by improving requirements relating to derecognition of financial assets and liabilities; and
- (c) the feedback the IASB received from national standard-setters on the largely favourable effects of the IFRS derecognition requirements during the financial crisis.

BC65C As a result, in June 2010 the IASB and the FASB agreed that their near-term priority was on increasing the transparency and comparability of their standards by improving and aligning the disclosure requirements in IFRSs and US GAAP for financial assets

²² IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

transferred to another entity. The boards also decided to conduct additional research and analysis, including a post-implementation review of some of the FASB's recently amended requirements, as a basis for assessing the nature and direction of any further efforts to improve or align IFRSs and US GAAP.

BC65D As a result, the Board decided to finalise the derecognition disclosures and related objectives, proposed in the exposure draft. Accordingly, in October 2010 the Board issued *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7), requiring disclosures to help users of financial statements:

- (a) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
- (b) to evaluate the nature of and risks associated with the entity's continuing involvement in derecognised financial assets.

Transferred financial assets that are not derecognised in their entirety

BC65E When financial assets are transferred but not derecognised, there has been an exchange transaction that is not reflected as such in the financial statements as a result of the accounting requirements. The Board concluded that in those situations, users of financial statements need to understand the relationship between those transferred financial assets and the associated liabilities that an entity recognises. Understanding that relationship helps users of financial statements in assessing an entity's cash flow needs and the cash flows available to the entity from its assets.

BC65F The Board observed that IFRS 7 required disclosures about transferred financial assets that are not derecognised in their entirety. The Board decided to continue requiring those disclosures because they provide information that is useful in understanding the relationship between transferred financial assets that are not derecognised and associated liabilities.

BC65G However, the Board also decided that the following additional disclosures were necessary:

- (a) a qualitative description of the nature of the relationship between transferred assets and associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets; and
- (b) a schedule that sets out the fair value of the transferred financial assets, the associated liabilities and the net position when the counterparty to the associated liabilities has recourse only to the transferred assets.

BC65H The Board concluded that these disclosures would provide information that is useful in assessing the extent to which the economic benefits generated by assets of an entity cannot be used in an unrestricted manner, as is implied when assets are recognised in an entity's statement of financial position. In addition, the disclosures would provide information about liabilities that will be settled entirely from the proceeds received from the transferred assets, and thus identify liabilities for which the counterparties do not have claims on the assets of the entity in general. For those assets for which the underlying cash flows are committed to be used to satisfy related liabilities, the Board noted that a schedule that sets out the fair value of the transferred financial assets, the associated liabilities and the net position (in addition to showing the cash flow relationship between those assets and liabilities) also provides a means of understanding the net exposure of an entity following a transfer transaction that fails derecognition.

Transferred financial assets that are derecognised in their entirety

- BC65I The Board was asked by users of financial statements, regulators and others to review the disclosure requirements for what are often described as 'off balance sheet' activities. Transfers of financial assets, particularly securitisation of financial assets, were identified as forming part of such activities.
- BC65J The Board concluded that when an entity retains continuing involvement in financial assets that it has derecognised, users of financial statements would benefit from information about the risks to which the entity remains exposed. Such information is relevant in assessing the amount, timing and uncertainty of the entity's future cash flows.
- BC65K The Board observed that IFRS 7 already requires certain disclosures by class of financial instrument or by type of risk. However, the IFRS requires the information at an aggregated level, so information specific to derecognition transactions is often not available. In response to requests from users and others the Board concluded that disclosures specific to derecognition transactions were necessary.
- BC65L The Board concluded that the disclosures should focus on the risk exposure of an entity, and should provide information about the timing of the return and the cash outflow that would or may be required to repurchase the derecognised financial assets in the future. The Board reasoned that a combination of disclosures about the strike price or repurchase price to repurchase assets, the fair value of its continuing involvement, the maximum exposure to loss and qualitative information about an entity's obligations to provide financial support are relevant in understanding an entity's exposure to risks.
- BC65M In addition, the Board concluded that information about an entity's gain or loss on derecognition and the timing of recognition of that gain or loss provides information about the proportion of an entity's profit or loss that arises from transferring financial assets in which the entity also retains continuing involvement. Such information is useful in assessing the extent to which an entity generates profits from transferring financial assets while retaining some form of continuing involvement and thus exposure to risk.
- BC65N The Board observed that the total amount of proceeds from transfer activity (that qualifies for derecognition) in a reporting period may not be evenly distributed throughout the reporting period (eg if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period). The Board decided that if transfer activity is concentrated around the end of reporting periods, disclosure of this fact provides an indication of whether transfer transactions are undertaken for the purpose of altering the appearance of the statement of financial position rather than for an ongoing commercial or financing purpose. In such cases, the amendments require disclosure of when the greatest transfer activity took place within that reporting period, the amount recognised from the transfer activity in that part of the reporting period, and the total amount of proceeds from transfer activity in that part of the reporting period.

Application of the disclosure requirements to a servicing contract

- BC65O Paragraphs 42A–42H of IFRS 7 require an entity to provide disclosures for all transferred financial assets that are not derecognised in their entirety and for any continuing involvement in a transferred asset that is derecognised in its entirety, existing at the reporting date, irrespective of when the related transfer transaction occurred.
- BC65P The Board received a request to clarify whether servicing contracts constitute continuing involvement for the purposes of applying the disclosure requirements in

paragraphs 42E–42H of IFRS 7. The question raised was whether paragraph 42C(c) of IFRS 7 excludes servicing contracts from the scope of those disclosure requirements.

BC65Q The Board observed that paragraph 42C(c) of IFRS 7 discusses arrangements whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities and the conditions in paragraph 3.2.5(a)–(c) of IFRS 9 are met; ie it is a ‘pass-through arrangement’.²³ Paragraph 42C(c) of IFRS 7 confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosure requirements. Consequently, the Board observed that the servicer’s obligation to pass through to one or more entities the cash flows that it collects from a transferred financial asset is not in itself continuing involvement for the purposes of the disclosure requirements, because the activity of passing through cash flows does not in itself constitute an interest in the future performance of the transferred financial asset. The Board observed, however, that a servicing contract is generally continuing involvement for the purposes of the transfer disclosure requirements because, in most cases, the servicer has an interest in the future performance of the transferred financial assets as a result of that contract. That would be the case if the amount and/or timing of the servicing fee depended on the amount and/or timing of the cash flows collected from the transferred financial asset. This would be true irrespective of how the servicer receives its servicing fee; ie whether the servicer retains a portion of the cash flows collected from the transferred financial asset as its fee or it passes through all of the cash flows collected and receives its fee separately from the transferee or another entity.

BC65R On the basis of these observations, the Board noted that paragraphs 42C and B30 of IFRS 7 are considered to determine whether a servicing contract gives rise to continuing involvement for the purposes of the transfer disclosure requirements. The Board decided to add guidance to the Application Guidance of IFRS 7 to clarify how the guidance in paragraph 42C of IFRS 7 is applied to servicing contracts.

BC65S During its discussions on this issue, the Board noted that for the purpose of applying the disclosure requirements in paragraphs 42E–42H of IFRS 7, continuing involvement as described in paragraph 42C of IFRS 7 has a different meaning from that used in paragraphs 3.2.6(c)(ii) and 3.2.16 of IFRS 9.²⁴ The Board considered, but decided against, making a clarification in respect of this point because it thought that this difference was already clear from the description of continuing involvement in the two IFRSs.

Effective date and transition (paragraphs 43 and 44)

BC66 The Board is committed to maintaining a “stable platform” of substantially unchanged Standards for annual periods beginning on or before 1 January 2005, when many entities will adopt IFRSs for the first time. In addition, some preparers will need time to make the system changes necessary to comply with the IFRS. Therefore, the Board decided that the effective date of IFRS 7 should be annual periods beginning on or after 1 January 2007, with earlier application encouraged.

BC67 The Board noted that entities that apply IFRS 7 only when it becomes mandatory will have sufficient time to prepare comparative information. This conclusion does not apply to entities that apply IFRS 7 early. In particular, the time would be extremely short for those entities that would like to apply IFRS 7 when they first adopt IFRSs in 2005, to avoid changing from local GAAP to IAS 32 and IAS 30 when they adopt IFRSs and then changing again to IFRS 7 only one or two years later. Therefore, the Board gave an exemption from providing comparative disclosure in the first year of application of IFRS 7 to any entity that both (a) is a first-time adopter of IFRSs and (b)

²³ If IFRS 9 has not been applied early, the equivalent reference is paragraph 19(a)–(c) of IAS 39.

²⁴ If IFRS 9 has not been applied early, the equivalent references are paragraphs 20(c)(ii) and 30 of IAS 39.

applies IFRS 7 before 1 January 2006. The Board noted that such an exemption for first-time adopters exists in IAS 32 and IFRS 4 and that the reasons for providing the exemption apply equally to IFRS 7.

- BC68 The Board also considered whether it should provide an exemption from presenting all or some of the comparative information to encourage early adoption of IFRS 7 by entities that already apply IFRSs.
- BC69 The Board noted that IFRS 7 contains two types of disclosures: accounting disclosures (in paragraphs 7-30) that are based on requirements previously in IAS 32 and new risk disclosures (in paragraphs 31-42). The Board concluded that existing users of IFRSs already will have complied with the requirements of IAS 32 and will not encounter difficulty in providing comparative information for the accounting disclosures.
- BC70 The Board noted that most of the risk disclosures, in particular those about market risk, are based on information collected at the end of the reporting period. The Board concluded that although IFRS 7 was published in August 2005, it will still be possible for entities to collect the information that they require to comply with IFRS 7 for accounting periods beginning in 2005. However, it would not always be possible to collect the information needed to provide comparative information about accounting periods that began in 2004. As a result, the Board decided that entities that apply IFRS 7 for accounting periods beginning in 2005 (ie before 1 January 2006) need not present comparative information about the risk disclosures.
- BC71 The Board also noted that comparative disclosures about risk are less relevant because these disclosures are intended to have predictive value. As a result information about risk loses relevance more quickly than other types of disclosure, and any disclosures required by previous GAAP are unlikely to be comparable with those required by IFRS 7. Accordingly, the Board decided that an entity that is not a first-time adopter and applies IFRS 7 for annual periods beginning before 1 January 2006 need not present comparative disclosures about the nature and extent of risks arising from financial instruments. In reaching this conclusion, the Board noted that the advantages of encouraging more entities to apply IFRS 7 early outweighed the disadvantage of the reduced information provided.
- BC72 The Board considered and rejected arguments that it should extend the exemption:
- (a) from providing comparative information to first-time adopters that applied IFRS 7 before 1 January 2007 (rather than only those that applied IFRS 7 before 1 January 2006). The Board concluded that an entity that intends to adopt IFRSs for the first time on or after 1 January 2006 will have sufficient time to collect information for its accounting period beginning on or after 1 January 2005 and, thus, should not have difficulty in providing the comparative disclosures for accounting periods beginning on or after 1 January 2006.
 - (b) from providing comparative disclosures about the significance of financial instruments to all entities adopting the IFRS for annual periods beginning before 1 January 2006 (rather than only to first-time adopters). The Board concluded that only first-time adopters warranted special relief so that they would be able to adopt IFRS 7 early without first having to adopt IAS 32 and IAS 30 for only one period. Entities that are not first-time adopters already apply IAS 32 and IAS 30 and have no particular need to adopt IFRS 7 before 1 January 2007.
 - (c) from providing comparative disclosures about risk to periods beginning before 1 January 2007 (rather than 2006). The Board noted that entities adopting IFRS 7 after 1 January 2006 would have a full calendar year to prepare after the publication of the IFRS.

BC72A *Annual Improvements to IFRSs 2012–2014 Cycle*, issued in September 2014, amended paragraph B30 and added paragraph B30A of IFRS 7. The Board considered whether the amendment should apply to any period presented that begins before the annual period for which the entity first applies the amendment. The Board noted that paragraph 42E(b) of IFRS 7 requires disclosure of the fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets. Application of the amendment to such a period might therefore require an entity to determine the fair value as at the end of the period for a servicing asset or servicing liability, which the entity might not have previously determined. It might be impracticable for an entity to determine the fair value of such a servicing asset or servicing liability without using hindsight. The Board also noted that paragraph 44M of IFRS 7 provides transition relief by which the entity need not apply the transfer disclosure requirements to comparative periods. Consequently, to avoid the risk of hindsight being applied, the Board decided to require the application of the amendment only to annual periods beginning on or after the beginning of the annual period for which the amendment is applied for the first time. Furthermore, for the same reason, the Board observed that those transition provisions should be available to first-time adopters. The Board has characterised the transition provisions in paragraph 44AA of IFRS 7 as retrospective despite this relief, because entities are required to look back to past derecognition events to determine whether a servicing asset or servicing liability needs to be disclosed.²⁵

Applicability of the offsetting amendments to IFRS 7 to condensed interim financial statements

BC72B The Board was asked to clarify the applicability of the amendments to IFRS 7 *Disclosure–Offsetting Financial Assets and Financial Liabilities* (the 'amendments to IFRS 7 concerning offsetting'), issued in December 2011, to condensed interim financial statements. It was asked to clarify the meaning of the reference to 'interim periods within those annual periods', used in paragraph 44R of IFRS 7. There was uncertainty about whether the disclosures required by paragraphs 13A–13F and B40–B53 of IFRS 7 were required to be included in condensed interim financial statements prepared in accordance with IFRS and, if so, whether those disclosures should be presented in every set of condensed interim financial statements, or only in those interim financial statements presented in the first year in which the disclosure requirements are effective or for which disclosure would be required under the principles in IAS 34 *Interim Financial Reporting*.

BC72C The Board noted that IAS 34 was not consequentially amended upon issue of the amendments to IFRS 7 concerning offsetting and that when the Board intends to require an entity to provide a disclosure in condensed interim financial statements in all circumstances it amends IAS 34. Consequently, the Board decided to amend paragraph 44R of IFRS 7 within the *Annual Improvements to IFRSs 2012–2014 Cycle* in order to clarify that the additional disclosure required by the amendments to IFRS 7 concerning offsetting is not specifically required for all interim periods. However, when considering this amendment, the Board noted that the additional disclosure is required to be given in condensed interim financial statements prepared in accordance with IAS 34 when its inclusion would be required in accordance with the general requirements of that IFRS. IAS 34 requires the disclosure of information in condensed interim financial statements when its omission would make the condensed interim financial statements misleading. The Board noted that in accordance with paragraph 15 of IAS 34 "an entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period". The Board further noted that in accordance with paragraph 25 of IAS 34: "The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period".

²⁵ *Annual Improvement to IFRS Standards 2014-2016 Cycle*, issued in December 2016, amended IFRS 1 *First-time Adoption of International Financial Reporting Standards* by deleting the short-term exemption for first-time adopters (see paragraph BC99 of IFRS 1), because it was no longer applicable.

Summary of main changes from the exposure draft

BC73 The main changes to the proposals in ED 7 are:

- (a) ED 7 proposed disclosure of the amount of change in the fair value of a financial liability designated as at fair value through profit or loss that is not attributable to changes in a benchmark interest rate as a proxy for the amount of change in fair value attributable to changes in the instrument's credit risk. The IFRS permits entities to determine the amount of change in fair value attributable to changes in the instrument's credit risk using an alternative method if the entity believes that its alternative method gives more faithful representation. The proxy disclosure has been amended to be the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk. As a result, entities may exclude factors other than a change in a benchmark interest rate when calculating the proxy.
- (b) a requirement has been added for disclosures about the difference between the transaction price at initial recognition (used as fair value in accordance with paragraph ~~AG76 of IAS 39~~²⁶ ~~B5.4.8 of IFRS 9~~) and the results of a valuation technique that will be used for subsequent measurement.
- (c) no disclosure is required of the fair value of collateral pledged as security and other credit enhancements as was proposed in ED 7.
- (d) the sensitivity analysis requirements have been clarified.
- (e) the exemption from presenting comparatives has been widened.
- (f) the capital disclosures are a stand-alone amendment to IAS 1, rather than part of the IFRS. No disclosure is required of whether the entity has complied with capital targets set by management and of the consequences of any non-compliance with those targets.
- (g) the amendments to IFRS 4 related to IFRS 7 have been modified to reduce systems changes for insurers.

²⁶ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence of issuing that IFRS, paragraph B5.4.8 of IFRS 9 was deleted. However, in 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraph B5.4.8 of IFRS 9 now contains requirements related to amortised cost measurement.

APPENDIX A

Amendments to Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 7. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

The amendments contained in this appendix when this Basis for Conclusions was issued have been incorporated into the relevant Basis for Conclusions.

*Guidance on Implementing
Hong Kong Financial Reporting Standard 7*

Financial Instruments: Disclosures



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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A Amendments to guidance on other IFRSs	

Guidance on Implementing IFRS 7 *Financial Instruments: Disclosures*

This guidance accompanies, but is not part of, IFRS 7.

Introduction

IG1 This guidance suggests possible ways to apply some of the disclosure requirements in IFRS 7. The guidance does not create additional requirements.

IG2 For convenience, each disclosure requirement in the IFRS is discussed separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risk.

IG3-IG4[Deleted]

Classes of financial instruments and level of disclosure (paragraphs 6 and B1-B3)

IG5 Paragraph B3 states that “an entity decides in the light of its circumstances how much detail it provides to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.” To satisfy the requirements, an entity may not need to disclose all the information suggested in this guidance.

IG6 Paragraph 17(c) of IAS 1 requires an entity to “provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.”

Significance of financial instruments for financial position and performance (Paragraphs 7-30, B4 and B5)²⁷

~~Financial liabilities at fair value through profit or loss— (paragraphs 10(a)(i) and B4)—~~

~~IG7- IG11 [Deleted] The following example illustrates the calculation that an entity might perform in accordance with paragraph B4 of Appendix B of the IFRS.~~

~~IG8 On 1 January 20X1, an entity issues a 10-year bond with a par value of CU150,000⁺ and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.~~

~~IG9 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:~~

~~(a) LIBOR has decreased to 4.75 per cent.~~

~~(b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.^{*}~~

²⁷ IFRS 9 *Financial Instruments* deleted paragraph B4 of IFRS 7.

⁺ In this guidance monetary amounts are denominated in “currency units (CU)”.

^{*} This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

~~IG10—The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.—~~

~~IG11—The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:—~~

~~[paragraph B4(a)]—~~ ~~First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.~~	~~At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent.~~ ~~Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.~~
~~[paragraph B4(b)]—~~ ~~Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B4(a).—~~	~~The contractual cash flows of the instrument at the end of the period are:~~ ~~• interest: CU12,000^(a) per year for each of years 2–10.—~~ ~~• principal: CU150,000 in year 10.—~~ ~~The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.—~~ ~~This gives a present value of CU152,367.^(b)—~~
~~[paragraph B4(c)]~~ ~~The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed~~	~~The market price of the liability at the end of the period is CU153,811.^(c)—~~ ~~Thus, the entity discloses CU1,444, which is CU153,811–CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.—~~
~~(a) CU150,000×8% = CU12,000—~~ ~~(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9}) / 0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$—~~ ~~(c) market price = $[CU12,000 \times (1 - (1 + 0.076)^{-9}) / 0.076] + CU150,000 \times (1 + 0.076)^{-9}$—~~	

Defaults and breaches (paragraphs 18 and 19)

- IG12 Paragraphs 18 and 19 require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IAS 1.

Total interest expense (paragraph 20(b))²⁸

- IG13 Total interest expense disclosed in accordance with paragraph 20(b) is a component of finance costs, which paragraph 82(b) of IAS 1 requires to be presented separately in the statement of comprehensive income. The line item for finance costs may also include amounts associated with non-financial liabilities.

~~Fair value (paragraphs 27-28)~~

- IG13A- [Deleted]
IG13B

Hedge accounting (paragraphs 24A–24C)

- IG13C Paragraph 24A of IFRS 7 requires that an entity discloses amounts related to items designated as hedging instruments in a tabular format. The following example illustrates how that information might be disclosed.

	<u>Nominal amount of the hedging instrument</u>	<u>Carrying amount of the hedging instrument</u>		<u>Line item in the statement of financial position where the hedging instrument is located</u>	<u>Changes in fair value used for calculating hedge ineffectiveness for 20X1</u>
		<u>Assets</u>	<u>Liabilities</u>		
<u>Cash flow hedges</u>					
<u>Commodity price risk</u> - Forward sales contracts	xx	xx	xx	Line item XX	xx
<u>Fair value hedges</u>					
<u>Interest rate risk</u> - Interest rate swaps	xx	xx	xx	Line item XX	xx
<u>Foreign exchange risk</u> - Foreign currency loan	xx	xx	xx	Line item XX	xx

²⁸ In *Improvements to IFRSs* issued in May 2008, the Board amended paragraph IG13 and removed 'total interest income' as a component of finance costs. This amendment removed an inconsistency with paragraph 32 of IAS 1 *Presentation of Financial Statements*, which precludes the offsetting of income and expenses (except when required or permitted by an IFRS).

IG13D Paragraph 24B of IFRS 7 requires that an entity discloses amounts related to items designated as hedged items in a tabular format. The following example illustrates how that information might be disclosed.

	<u>Carrying amount of the hedged item</u>		<u>Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item</u>		<u>Line item in the statement of financial position in which the hedged item is included</u>	<u>Change in value used for calculating hedge ineffectiveness for 20X1</u>	<u>Cash flow hedge reserve</u>
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>			
Cash flow hedges							
<u>Commodity price risk</u>							
- <u>Forecast sales</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>xx</u>	<u>xx</u>
- <u>Discontinued hedges (forecast sales)</u>							
	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>xx</u>
Fair value hedges							
<u>Interest rate risk</u>							
- <u>Loan payable</u>	<u>=</u>	<u>xx</u>	<u>=</u>	<u>xx</u>	<u>Line item XX</u>	<u>xx</u>	<u>n/a</u>
- <u>Discontinued hedges (Loan payable)</u>							
	<u>=</u>	<u>xx</u>	<u>=</u>	<u>xx</u>	<u>Line item XX</u>	<u>n/a</u>	<u>n/a</u>
<u>Foreign exchange risk</u>							
- <u>Firm commitment</u>							
	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>Line item XX</u>	<u>xx</u>	<u>n/a</u>

IG13E Paragraph 24C of IFRS 7 requires that an entity discloses amounts that have affected the statement of comprehensive income as a result of applying hedge accounting in a tabular format. The following example illustrates how that information might be disclosed.

<u>Cash flow hedges^(a)</u>	<u>Separate line item recognised in profit or loss as a result of a hedge of a net position^(b)</u>	<u>Change in the value of the hedging instrument recognised in other comprehensive income</u>	<u>Hedge ineffectiveness recognised in profit or loss</u>	<u>Line item in profit or loss (that includes hedge ineffectiveness)</u>	<u>Amount reclassified from the cash flow hedge reserve to profit or loss</u>	<u>Line item affected in profit or loss because of the reclassification</u>
<u>Commodity price risk</u>						
<u>Commodity X - Discontinued hedge</u>	<u>n/a</u>	<u>xx</u>	<u>xx</u>	<u>Line item XX</u>	<u>xx</u>	<u>Line item XX</u>
	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>n/a</u>	<u>xx</u>	<u>Line item XX</u>
(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.						
(b) This disclosure only applies to cash flow hedges of foreign currency risk.						

<u>Fair value hedges</u>	<u>Ineffectiveness recognised in profit or loss</u>	<u>Line item(s) in profit or loss (that include(s) hedge ineffectiveness)</u>
<u>Interest rate risk</u>	<u>xx</u>	<u>Line item XX</u>
<u>Foreign exchange risk</u>	<u>xx</u>	<u>Line item XX</u>

Fair value (paragraph 28)

IG14 ~~The fair value of~~ At initial recognition an entity measures the fair value of financial instruments that are not traded in active markets. ~~is measured in accordance with IFRS 13 Fair Value Measurement and paragraph AG76 of IAS 39.~~ However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognised in profit or loss in subsequent periods in accordance with ~~IAS 39~~ IFRS 9 Financial Instruments and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would take into account when pricing the asset or liability (see paragraph ~~AG76(b) of IAS 39~~ B5.1.2A(b) of IFRS 9). Paragraph 28 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 28:

Background

On 1 January 20X1 an entity purchases for CU15 million financial assets that are not traded in an active market. The entity has only one class of such financial assets.

The transaction price of CU15 million is the fair value at initial recognition.

After initial recognition, the entity will apply a valuation technique to measure the financial assets' fair value. This valuation technique use inputs other than data from observable markets.

At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million.

The entity has existing differences of CU5 million at 1 January 20X1.

Application of requirements

The entity's 20X2 disclosure would include the following:

Accounting policies

The entity uses the following valuation technique to measure the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IFRS 13 and ~~IAS 39~~ IFRS 9, is normally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IFRS 13 and ~~IAS 39~~ IFRS 9, the fair value of an instrument at inception is normally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

The differences yet to be recognised in profit or loss are as follows:

	31 Dec X2 CU million	31 Dec X1 CU million
Balance at beginning of year	5.3	5.0
New transactions	-	1.0
Amounts recognised in profit or loss during the year	(0.7)	(0.8)
Other increases	-	0.2
Other decreases	<u>(0.1)</u>	<u>(0.1)</u>
Balance at end of year	<u><u>4.5</u></u>	<u><u>5.3</u></u>

Nature and extent of risks arising from financial instruments (paragraphs 31-42 and B6-B28)

Qualitative disclosures (paragraph 33)

- IG15 The type of qualitative information an entity might disclose to meet the requirements in paragraph 33 includes, but is not limited to, a narrative description of:
- (a) the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.
 - (b) the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:
 - (i) the structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability;
 - (ii) the scope and nature of the entity's risk reporting or measurement systems;
 - (iii) the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
 - (iv) the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.
 - (c) the entity's policies and procedures for avoiding excessive concentrations of risk.
- IG16 Information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful.
- IG17 In accordance with paragraph 33(c), entities disclose any change in the qualitative information from the previous period and explain the reasons for the change. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed.

Quantitative disclosures (paragraphs 34-42 and B7-B28)

- IG18 Paragraph 34 requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:
- (a) industry sectors. Thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties.
 - (b) credit rating or other measure of credit quality. Thus, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.

- (c) geographical distribution. Thus, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.
- (d) a limited number of individual counterparties or groups of closely related counterparties.

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

- IG19 In accordance with paragraph B8, disclosure of concentrations of risk includes a description of the shared characteristic that identifies each concentration. For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries.
- IG20 When quantitative information at the end of the reporting period is unrepresentative of the entity's exposure to risk during the period, paragraph 35 requires further disclosure. To meet this requirement, an entity might disclose the highest, lowest and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures.

Credit risk (paragraphs 35A–36, B8A–B10)

- IG20A The following examples illustrate possible ways in which an entity might provide the disclosures required by paragraphs 35A–35N of IFRS 7. However, these illustrations do not address all possible ways of applying the disclosure requirements.

Illustrating the application of paragraphs 35H and 35I

- IG20B The following example illustrates one way of providing information about the changes in the loss allowance and the significant changes in the gross carrying amount of financial assets during the period that contributed to changes in the loss allowance as required by paragraphs 35H–35I. This example does not illustrate the requirements for financial assets that are purchased or originated credit-impaired.

<u>Mortgage loans—loss allowance</u>	<u>12-month expected credit losses</u>	<u>Lifetime expected credit losses (collectively assessed)</u>	<u>Lifetime expected credit losses (individually assessed)</u>	<u>Credit-impaired financial assets (lifetime expected credit losses)</u>
<u>CU'000</u>				
<u>Loss allowance as at 1 January</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
<u>Changes due to financial instruments recognised as at 1 January:</u>				
<u>- Transfer to lifetime expected credit losses</u>	<u>(X)</u>	<u>X</u>	<u>X</u>	<u>=</u>
<u>- Transfer to credit-impaired financial assets</u>	<u>(X)</u>	<u>=</u>	<u>(X)</u>	<u>X</u>
<u>- Transfer to 12-month expected credit losses</u>	<u>X</u>	<u>(X)</u>	<u>(X)</u>	<u>=</u>
<u>- Financial assets that have been derecognised during the period</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>
<u>New financial assets originated or purchased</u>	<u>X</u>	<u>=</u>	<u>=</u>	<u>=</u>
<u>Write-offs</u>	<u>=</u>	<u>=</u>	<u>(X)</u>	<u>(X)</u>
<u>Changes in models/risk parameters</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
<u>Foreign exchange and other movements</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
<u>Loss allowance as at 31 December</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x per cent, with a corresponding increase in the loss allowance measured on a 12-month basis.
- The write off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- The expected increase in unemployment in Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and caused a net increase of CUX in the lifetime expected credit losses allowance.

The significant changes in the gross carrying amount of mortgage loans are further explained below:

<u>Mortgage loans—gross carrying amount</u>	<u>12-month expected credit losses</u>	<u>Lifetime expected credit losses (collectively assessed)</u>	<u>Lifetime expected credit losses (individually assessed)</u>	<u>Credit-impaired financial assets (lifetime expected credit losses)</u>
CU'000				
<u>Gross carrying amount as at 1 January</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
Individual financial assets transferred to lifetime expected credit losses	(X)	=	X	=
Individual financial assets transferred to credit-impaired financial assets	(X)	=	(X)	X
Individual financial assets transferred from credit-impaired financial assets	X	=	X	(X)
Financial assets assessed on collective basis	(X)	X	=	=
New financial assets originated or purchased	X	=	=	=
Write-offs	=	=	(X)	(X)
Financial assets that have been derecognised	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	=	(X)	(X)
Other changes	X	X	X	X
<u>Gross carrying amount as at 31 December</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>

Illustrating the application of paragraphs 35M and 35N

IG20C The following example illustrates some ways of providing information about an entity's credit risk exposure and significant credit risk concentrations in accordance with paragraph 35M of IFRS 7. The number of grades used to disclose the information in accordance with paragraph 35M of IFRS 7 shall be consistent with the number that the entity uses to report internally to key management personnel for internal credit risk management purposes. However, if information about credit risk rating grades is not available without undue cost or effort and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 5.5.11 of IFRS 9, the entity shall provide an analysis by past due status for those financial assets.

<u>Consumer loan credit risk exposure by internal rating grades</u>				
<u>20XX</u>	<u>Consumer—credit card</u>		<u>Consumer—automotive</u>	
<u>CU'000</u>	<u>Gross carrying amount</u>		<u>Gross carrying amount</u>	
	<u>Lifetime</u>	<u>12-month</u>	<u>Lifetime</u>	<u>12-month</u>
<u>Internal Grade 1–2</u>	X	X	X	X
<u>Internal Grade 3–4</u>	X	X	X	X
<u>Internal Grade 5–6</u>	X	X	X	X
<u>Internal Grade 7</u>	X	X	X	X
Total	X	X	X	X

<u>Corporate loan credit risk profile by external rating grades</u>				
<u>20XX</u>	<u>Corporate—equipment</u>		<u>Corporate—construction</u>	
<u>CU'000</u>	<u>Gross carrying amount</u>		<u>Gross carrying amount</u>	
	<u>Lifetime</u>	<u>12-month</u>	<u>Lifetime</u>	<u>12-month</u>
<u>AAA-AA</u>	X	X	X	X
<u>A</u>	X	X	X	X
<u>BBB-BB</u>	X	X	X	X
<u>B</u>	X	X	X	X
<u>CCC-CC</u>	X	X	X	X
<u>C</u>	X	X	X	X
<u>D</u>	X	X	X	X
Total	X	X	X	X

<u>Corporate loan risk profile by probability of default</u>				
<u>20XX</u>	<u>Corporate—unsecured</u>		<u>Corporate—secured</u>	
<u>CU'000</u>	<u>Gross carrying amount</u>		<u>Gross carrying amount</u>	
	<u>Lifetime</u>	<u>12-month</u>	<u>Lifetime</u>	<u>12-month</u>
<u>0.00 – 0.10</u>	X	X	X	X
<u>0.11 – 0.40</u>	X	X	X	X
<u>0.41 – 1.00</u>	X	X	X	X
<u>1.01 – 3.00</u>	X	X	X	X
<u>3.01 – 6.00</u>	X	X	X	X
<u>6.01 – 11.00</u>	X	X	X	X
<u>11.01 – 17.00</u>	X	X	X	X
<u>17.01 – 25.00</u>	X	X	X	X
<u>25.01 – 50.00</u>	X	X	X	X
<u>50.01+</u>	X	X	X	X
Total	X	X	X	X

IG20D Entity A manufactures cars and provides financing to both dealers and end customers. Entity A discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so that the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach:

<u>20XX</u> <u>CU'000</u>	<u>Trade receivables days past due</u>				
<u>Dealer</u> <u>financing</u>	<u>Current</u>	<u>More than 30</u> <u>days</u>	<u>More than 60</u> <u>days</u>	<u>More than 90</u> <u>days</u>	<u>Total</u>
<u>Expected credit</u> <u>loss rate</u> <u>Estimated total</u> <u>gross carrying</u> <u>amount at</u> <u>default</u>	<u>0.10%</u> <u>CU20,777</u>	<u>2%</u> <u>CU1,416</u>	<u>5%</u> <u>CU673</u>	<u>13%</u> <u>CU235</u>	<u>CU23,101</u>
<u>Lifetime</u> <u>expected credit</u> <u>losses—dealer</u> <u>financing</u>	<u>CU21</u>	<u>CU28</u>	<u>CU34</u>	<u>CU31</u>	<u>CU114</u>
<u>Customer</u> <u>financing</u>					
<u>Expected credit</u> <u>loss rate</u> <u>Estimated total</u> <u>gross carrying</u> <u>amount at</u> <u>default</u>	<u>0.20%</u> <u>CU19,222</u>	<u>3%</u> <u>CU2,010</u>	<u>8%</u> <u>CU301</u>	<u>15%</u> <u>CU154</u>	<u>CU21,687</u>
<u>Lifetime</u> <u>expected credit</u> <u>losses—</u> <u>customer</u> <u>financing</u>	<u>CU38</u>	<u>CU60</u>	<u>CU24</u>	<u>CU23</u>	<u>CU145</u>

~~Credit risk (paragraphs 36–38, B9 and B10)~~

IG21 Paragraph 36 requires an entity to disclose information about its exposure to credit risk by class of financial instrument. Financial instruments in the same class share economic characteristics with respect to the risk being disclosed (in this case, credit risk). For example, an entity might determine that residential mortgages, unsecured consumer loans, and commercial loans each have different economic characteristics.

Collateral and other credit enhancements pledged (paragraph 36(b))

IG22 Paragraph 36(b) requires an entity to describe collateral available as security for assets it holds and other credit enhancements obtained. An entity might meet this requirement by disclosing:

- the policies and processes for valuing and managing collateral and other credit enhancements obtained;
- a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with IAS 32);
- the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and

- (d) information about risk concentrations within the collateral or other credit enhancements.

Credit quality (paragraph 36(e))

~~IG23- IG31~~ ~~[Deleted] Paragraph 36(e) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:~~

- ~~(a) an analysis of credit exposures using an external or internal credit grading system;—~~
- ~~(b) the nature of the counterparty;—~~
- ~~(c) historical information about counterparty default rates; and—~~
- ~~(d) any other information used to assess credit quality.—~~

~~IG24~~ ~~When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:—~~

- ~~(a) the amounts of credit exposures for each external credit grade;—~~
- ~~(b) the rating agencies used;—~~
- ~~(c) the amount of an entity's rated and unrated credit exposures; and—~~
- ~~(d) the relationship between internal and external ratings.—~~

~~IG25~~ ~~When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:—~~

- ~~(a) the internal credit ratings process;—~~
- ~~(b) the amounts of credit exposures for each internal credit grade; and—~~
- ~~(c) the relationship between internal and external ratings.—~~

Financial assets that are either past due or impaired (paragraph 37)

~~IG26~~ ~~A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.—~~

~~IG27~~ ~~When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.—~~

~~IG28~~ ~~Paragraph 37(a) requires an analysis by class of the age of financial assets that are past due but not impaired. An entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:—~~

- ~~(a) not more than three months;—~~
- ~~(b) more than three months and not more than six months;—~~

~~(c) — more than six months and not more than one year; and~~

~~(d) — more than one year.~~

~~IG29 Paragraph 37(b) requires an analysis of impaired financial assets by class. This analysis might include:~~

~~(a) — the carrying amount, before deducting any impairment loss;~~

~~(b) — the amount of any related impairment loss; and~~

~~(c) — the nature and fair value of collateral available and other credit enhancements obtained.~~

~~IG30 [Deleted]~~

~~IG31~~

Market risk (paragraphs 40-42 and B17-B28)

IG32 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk and other price risk. Other price risk may include risks such as equity price risk, commodity price risk, prepayment risk (ie the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (eg a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to:

- (a) the yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.
- (b) foreign exchange rates.
- (c) prices of equity instruments.
- (d) market prices of commodities.

IG33 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:

- (a) prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan; or
- (b) currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

IG34 For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

- (a) interest income and expense;
- (b) other line items of profit or loss (such as trading gains and losses); and
- (c) when applicable, equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

IG35 Because the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a

sensitivity analysis of market risk varies for each entity and for each type of market risk.

- IG36 The following example illustrates the application of the disclosure requirement in paragraph 40(a):

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X1–CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, and other comprehensive income would have been CU2.8 million (20X1–CU3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X1–CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, and other comprehensive income would have been CU3.0 million (20X1–CU3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).^(a)

Foreign currency exchange rate risk

At 31 December 20X2, if the CU had weakened 10 per cent against the US dollar with all other variables held constant, post-tax profit for the year would have been CU2.8 million (20X1–CU6.4 million) lower, and other comprehensive income would have been CU1.2 million (20X1–CU1.1 million) higher. Conversely, if the CU had strengthened 10 per cent against the US dollar with all other variables held constant, post-tax profit would have been CU2.8 million (20X1–CU6.4 million) higher, and other comprehensive income would have been CU1.2 million (20X1–CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in profit in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Equity is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

(a) Paragraph 39(a) requires disclosure of a maturity analysis of liabilities.

Other market risk disclosures (paragraph 42)

- IG37 Paragraph 42 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

- (a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, eg options that remain out of (or in) the money for the chosen change in the risk variable;
- (b) financial assets are illiquid, eg when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or
- (c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

IG38 In the situation in paragraph IG37(a), additional disclosure might include:

- (a) the terms and conditions of the financial instrument (eg the options);
- (b) the effect on profit or loss if the term or condition were met (ie if the options were exercised); and
- (c) a description of how the risk is hedged.

For example, an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (eg the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

IG39 In the situation described in paragraph IG37(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40 In the situation described in paragraph IG37(c), additional disclosure might include:

- (a) the nature of the security (eg entity name);
- (b) the extent of holding (eg 15 per cent of the issued shares);
- (c) the effect on profit or loss; and
- (d) how the entity hedges the risk.

Derecognition (paragraphs 42D and 42E)

IG40A The following examples illustrate some possible ways to meet the quantitative disclosure requirements in paragraphs 42D and 42E.

IG40B The following examples illustrate how an entity that has adopted IFRS 9 *Financial Instruments* might meet the quantitative disclosure requirements in paragraphs 42D and 42E.

Transferred financial assets that are not derecognised in their entirety

Illustrating the application of paragraph 42D(d) and (e)

	Financial assets at fair value through profit or loss		Financial assets at amortised cost		Financial assets at fair value through other comprehensive income
	CU million		CU million		CU million
	Trading assets	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

Transferred financial assets that are derecognised in their entirety**Illustrating the application of paragraph 42E(a)–(d)**

	Cash outflows to repurchase transferred (derecognised) assets	Carrying amount of continuing involvement in statement of financial position			Fair value of continuing involvement		Maximum exposure to loss
	CU million	CU million			CU million		CU million
Type of continuing involvement		Financial assets at fair value through profit or loss	Financial assets at fair value through other comprehensive income	Financial liabilities at fair value through profit or loss	Assets	Liabilities	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)			(X)	X	(X)	X
Total		X		(X)	X	(X)	X

Illustrating the application of paragraph 42E(e)

Undiscounted cash flows to repurchase transferred assets								
	Maturity of continuing involvement CU million							
Type of continuing involvement	Total	less than 1 month	1–3 months	3–6 months	6 months – 1 year	1–3 years	3–5 years	more than 5 years
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					

IG40C The following examples illustrate how an entity that has not adopted IFRS 9 might meet the quantitative disclosure requirements in paragraphs 42D and 42E.

Transferred financial assets that are not derecognised in their entirety

Illustrating the application of paragraph 42D(d) and (e)

	Financial assets at fair value through profit or loss		Loans and receivables		Available-for-sale financial assets
	CU million		CU million		CU million
	Trading securities	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

Transferred financial assets that are derecognised in their entirety**Illustrating the application of paragraph 42E(a)–(d)**

	Cash outflows to repurchase transferred (derecognised) assets	Carrying amount of continuing involvement in statement of financial position			Fair value of continuing involvement		Maximum exposure to loss
	CU million	CU million			CU million		CU million
Type of continuing involvement		Held for trading	Available-for-sale financial assets	Financial liabilities at fair value through profit or loss	Assets	Liabilities	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)		X	(X)	X	(X)	X
Total		X	X	(X)	X	(X)	X

Illustrating the application of paragraph 42E(e)

Undiscounted cash flows to repurchase transferred assets								
	Maturity of continuing involvement CU million							
Type of continuing involvement	Total	less than 1 month	1–3 months	3–6 months	6 months –1 year	1–3 years	3–5 years	more than 5 years
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					

Disclosures (paragraphs 13A–13F and B40–B53)

IG40D The following examples illustrate ways in which an entity might provide the quantitative disclosures required by paragraph 13C. However, these illustrations do not address all possible ways of applying the disclosure requirements as set out in paragraphs 13B–13E.

Background

An entity has entered into transactions subject to an enforceable master netting arrangement or similar agreement with the following counterparties. The entity has the following recognised financial assets and financial liabilities resulting from those transactions that meet the scope of the disclosure requirements in paragraph 13A.

Counterparty A:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty A that meet the offsetting criteria in paragraph 42 of IAS 32. Consequently, the gross derivative liability is set off against the gross derivative asset, resulting in the presentation of a net derivative asset of CU20 million in the entity's statement of financial position. Cash collateral has also been received from Counterparty A for a portion of the net derivative asset (CU10 million). The cash collateral of CU10 million does not meet the offsetting criteria in paragraph 42 of IAS 32, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty B:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty B that do not meet the offsetting criteria in paragraph 42 of IAS 32, but which the entity has the right to set off in the case of default and insolvency or bankruptcy. Consequently, the gross amount of the derivative asset (CU100 million) and the gross amount of the derivative liability (CU80 million) are presented separately in the entity's statement of financial position. Cash collateral has also been received from Counterparty B for the net amount of the derivative asset and derivative liability (CU20 million). The cash collateral of CU20 million does not meet the offsetting criteria in paragraph 42 of IAS 32, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

continued...

*...continued***Counterparty C:**

The entity has entered into a sale and repurchase agreement with Counterparty C that is accounted for as a collateralised borrowing. The carrying amount of the financial assets (bonds) used as collateral and posted by the entity for the transaction is CU79 million and their fair value is CU85 million. The carrying amount of the collateralised borrowing (repo payable) is CU80 million.

The entity has also entered into a reverse sale and repurchase agreement with Counterparty C that is accounted for as a collateralised lending. The fair value of the financial assets (bonds) received as collateral (and not recognised in the entity's statement of financial position) is CU105 million. The carrying amount of the collateralised lending (reverse repo receivable) is CU90 million.

The transactions are subject to a global master repurchase agreement with a right of set-off only in default and insolvency or bankruptcy and therefore do not meet the offsetting criteria in paragraph 42 of IAS 32. Consequently, the related repo payable and repo receivable are presented separately in the entity's statement of financial position.

Illustrating the application of paragraph 13C(a)–(e) by type of financial instrument

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	Related amounts not set off in the statement of financial position		Net amount
Description				(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	
Derivatives	200	(80)	120	(80)	(30)	10
Reverse repurchase, securities borrowing and similar agreements	90	-	90	(90)	-	-
Other financial instruments	-	-	-	-	-	-
Total	290	(80)	210	(170)	(30)	10

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				Related amounts not set off in the statement of financial position		
	Gross amounts of recognised financial assets	Gross amounts of recognised financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	Net amount
Description						
Derivatives	160	(80)	80	(80)	-	-
Repurchase, securities lending and similar agreements	80	-	80	(80)	-	-
Other financial instruments	-	-	-	-	-	-
Total	240	(80)	160	(160)	-	-

Illustrating the application of paragraph 13C(a)–(c) by type of financial instrument and paragraph 13C(c)–(e) by counterparty

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position
Description			
Derivatives	200	(80)	120
Reverse repurchase, securities borrowing and similar agreements	90	-	90
Other financial instruments	-	-	-
Total	290	(80)	210

Net financial assets subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

As at 31 December 20XX	(c)	(d)		(e)=(c)-(d)
	Net amounts of financial assets presented in the statement of financial position	Related amounts not set off in the statement of financial position		Net amount
		(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	
Counterparty A	20	-	(10)	10
Counterparty B	100	(80)	(20)	-
Counterparty C	90	(90)	-	-
Other	-	-	-	-
Total	210	(170)	(30)	10

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial liabilities	Gross amounts of recognised financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position
Description			
Derivatives	160	(80)	80
Repurchase, securities lending and similar agreements	80	-	80
Other financial instruments	-	-	-
Total	240	(80)	160

Net financial liabilities subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

As at 31 December 20XX	(c)	(d)		(e)=(c)-(d)
	Net amounts of financial liabilities presented in the statement of financial position	Related amounts not set off in the statement of financial position		Net amount
		(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	
Counterparty A	-	-	-	-
Counterparty B	80	(80)	-	-
Counterparty C	80	(80)	-	-
Other	-	-	-	-
Total	160	(160)	-	-

Transition from IAS 39 to IFRS 9 (paragraphs 42K-42O)

IG40E The following illustration is an example of one possible way to meet the quantitative disclosure requirements in paragraphs 42K–42O of IFRS 7 at the date of initial application of IFRS 9. However, this illustration does not address all possible ways of applying the disclosure requirements of this IFRS.

Reconciliation of statement of financial position balances from IAS 39 to IFRS 9 at 1 January 2018

<u>Financial assets</u>	<u>(i)</u>	<u>(ii)</u>	<u>(iii)</u>	<u>(iv) = (i)</u> <u>+ (ii) +</u> <u>(iii)</u>	<u>(v) = (iii)</u>
	<u>IAS 39</u> <u>carrying</u> <u>amount 31</u> <u>December</u> <u>2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>IFRS 9</u> <u>carrying</u> <u>amount</u> <u>1</u> <u>January</u> <u>2018</u>	<u>Retained</u> <u>earnings</u> <u>effect on</u> <u>1</u> <u>January</u> <u>2018 (2),</u> <u>(3)</u>
<u>Fair value through</u> <u>profit or loss</u>					
<u>Additions:</u>					
<u>From available for</u> <u>sale (IAS 39)</u>		<u>(a)</u>			<u>(c)</u>
<u>From amortised cost</u> <u>(IAS 39) – required</u> <u>reclassification</u>		<u>(b)</u>			
<u>From amortised cost</u> <u>(IAS 39) – fair value</u> <u>option elected at 1</u> <u>January 2018</u>					
<u>Subtractions:</u>					
<u>To amortised cost</u> <u>(IFRS 9)</u>					
<u>To fair value through</u> <u>other comprehensive</u> <u>income – debt</u> <u>instruments (IFRS 9)</u>					
<u>To fair value through</u> <u>other comprehensive</u> <u>income – equity</u> <u>instruments (IFRS 9)</u>					
<u>Total change to fair</u> <u>value through profit</u> <u>or loss</u>					
<u>Fair value through</u> <u>other</u> <u>comprehensive</u> <u>income</u>					
<u>Additions – debt</u> <u>instruments:</u>					
<u>From available for</u> <u>sale (IAS 39)</u>					<u>(g)</u>
<u>From amortised cost</u> <u>(IAS 39)</u>					<u>(h)</u>
					<u>continued...</u>

Reconciliation of statement of financial position balances from IAS 39 to IFRS 9 at 1 January 2018

<u>Financial assets</u>	<u>(i)</u>	<u>(ii)</u>	<u>(iii)</u>	<u>(iv) = (i) + (ii) + (iii)</u>	<u>(v) = (iii)</u>
	<u>IAS 39 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>IFRS 9 carrying amount 1 January 2018</u>	<u>Retained earnings effect on 1 January 2018 (2), (3)</u>
<u>From fair value through profit or loss (IAS 39) – required reclassification based on classification criteria</u>					<u>(i)</u>
<u>From fair value through profit or loss (fair value option under IAS 39) – fair value option criteria not met at 1 January 2018</u>					<u>(i)</u>
<u>From fair value through profit or loss (IAS 39) – fair value option revoked at 1 January 2018 by choice</u>					<u>(k)</u>
<u>Additions – equity instruments:</u>					
<u>From available-for-sale (IAS 39)</u>					
<u>From fair value through profit or loss (fair value option under IAS 39) – fair value through other comprehensive income elected at 1 January 2018</u>					
<u>From cost (IAS 39)</u>					
<u>Subtractions – debt and equity instruments:</u>					

continued...

Reconciliation of statement of financial position balances from IAS 39 to IFRS 9 at 1 January 2018

Financial assets	(i)	(ii)	(iii)	(iv) = (i) + (ii) + (iii)	(v) = (iii)
	<u>IAS 39 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>IFRS 9 carrying amount 1 January 2018</u>	<u>Retained earnings effect on 1 January 2018 (2), (3)</u>
Available for sale (IAS 39) to fair value through profit or loss (IFRS 9) – required reclassification based on classification criteria					(d)
Available for sale (IAS 39) to fair value through profit or loss (IFRS 9) – fair value option elected at 1 January 2018					
Available for sale (IAS 39) to amortised cost (IFRS 9)					(e)
<u>Total change to fair value through other comprehensive income</u>					
<u>Amortised cost</u>					
Additions:					
From available for sale (IAS 39)					(f)
From fair value through profit or loss (IAS 39) – required reclassification					
From fair value through profit or loss (fair value option under IAS 39) – fair value option criteria not met at 1 January 2018					
From fair value through profit or loss (IAS 39) – fair value option revoked at 1 January 2018 by choice					

continued...

Reconciliation of statement of financial position balances from IAS 39 to IFRS 9 at 1 January 2018

<u>Financial assets</u>	<u>(i)</u>	<u>(ii)</u>	<u>(iii)</u>	<u>(iv) = (i)</u> <u>+ (ii) +</u> <u>(iii)</u>	<u>(v) = (iii)</u>
	<u>IAS 39</u> <u>carrying</u> <u>amount 31</u> <u>December</u> <u>2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>IFRS 9</u> <u>carrying</u> <u>amount</u> <u>1</u> <u>January</u> <u>2018</u>	<u>Retained</u> <u>earnings</u> <u>effect on</u> <u>1</u> <u>January</u> <u>2018 (2),</u> <u>(3)</u>
Subtractions:					
To fair value through other comprehensive income (IFRS 9)					(l)
To fair value through profit or loss (IFRS 9) – required reclassification based on classification criteria					
To fair value through profit or loss (IFRS 9) – fair value option elected at 1 January 2018					
Total change to amortised cost					
Total financial asset balances, reclassifications and remeasurements at 1 January 2018	<u>(i)</u>	<u>Total (ii) = 0</u>	<u>(iii)</u>	<u>(iv) =</u> <u>(i) + (ii)</u> <u>+ (iii)</u>	

- 1 Includes the effect of reclassifying hybrid instruments that were bifurcated under IAS 39 with host contract components of (a), which had associated embedded derivatives with a fair value of X at 31 December 2017, and (b), which had associated embedded derivatives with a fair value of Y at 31 December 2017.
- 2 Includes (c), (d), (e) and (f), which are amounts reclassified from other comprehensive income to retained earnings at the date of initial application.
- 3 Includes (g), (h), (i), (j), (k) and (l), which are amounts reclassified from retained earnings to accumulated other comprehensive income at the date of initial application.

Transition (paragraph 44)

IG41 The following table summarises the effect of the exemption from presenting comparative accounting and risk disclosures for accounting periods beginning before 1 January 2006, before 1 January 2007, and on or after 1 January 2007. In this table:

- (a) a **first-time adopter** is an entity preparing its first IFRS financial statements (see IFRS 1 *First-time Adoption of International Financial Reporting Standards*).

- (b) an **existing IFRS user** is an entity preparing its second or subsequent IFRS financial statements.

	Accounting disclosures (paragraphs 7-30)	Risk disclosures (paragraphs 31-42)
Accounting periods beginning before 1 January 2006		
First-time adopter not applying IFRS 7 early	<i>Applies IAS 32 but exempt from providing IAS 32 comparative information</i>	<i>Applies IAS 32 but exempt from providing IAS 32 comparative information</i>
First-time adopter applying IFRS 7 early	Exempt from presenting IFRS 7 comparative information	Exempt from presenting IFRS 7 comparative information
Existing IFRS user not applying IFRS 7 early	Applies IAS 32. Provides full IAS 32 comparative information	Applies IAS 32. Provides full IAS 32 comparative information
Existing IFRS user applying IFRS 7 early	Provides full IFRS 7 comparative information	Exempt from presenting IFRS 7 comparative information^(a)
<i>continued ...</i>		

Accounting periods beginning on or after 1 January 2006 and before 1 January 2007		
First-time adopter not applying IFRS 7 early	Applies IAS 32. Provides full IAS 32 comparative information	Applies IAS 32. Provides full IAS 32 comparative information
First-time adopter applying IFRS 7 early	Provides full IFRS 7 comparative information	Provides full IFRS 7 comparative information
Existing IFRS user not applying IFRS 7 early	Applies IAS 32. Provides full IAS 32 comparative information	Applies IAS 32. Provides full IAS 32 comparative information
Existing IFRS user applying IFRS 7 early	Provides full IFRS 7 comparative information	Provides full IFRS 7 comparative information
Accounting periods beginning on or after 1 January 2007 (mandatory application of IFRS 7)		
First-time adopter	Provides full IFRS 7 comparative information	Provides full IFRS 7 comparative information
Existing IFRS user	Provides full IFRS 7 comparative information	Provides full IFRS 7 comparative information
(a) See paragraph 44 of IFRS 7		

APPENDIX A

Amendments to guidance on other IFRSs

This appendix contains amendments to guidance on IFRSs other than IFRS 4 that are necessary in order to ensure consistency with IFRS 7. Amendments to the Guidance on Implementing IFRS 4 will be published at a later date. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

The amendments contained in this appendix when this Implementation Guidance was issued have been incorporated into the relevant Implementation Guidance.

HKFRS 9
~~Issued November 2017~~ Revised September 2018

Hong Kong Financial Reporting Standard 9 (2014)

Financial Instruments



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Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9) is set out in paragraphs 1.1–7.3.2 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 9 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Appendix C

Amendments to other Standards

Except where otherwise stated, an entity shall apply the amendments in this appendix when it applies HKFRS 9 issued in September 2014. These amendments incorporate with additions the amendments issued in Appendix C of HKFRS 9 in 2009, 2010 and 2013. The amendments in this appendix also incorporate the amendments made by Standards issued before HKFRS 9 (2014), even if those other Standards were not mandatorily effective at the time HKFRS 9 (2014) was issued. Notably, the amendments in this appendix incorporate the amendments made by HKFRS 15 Revenue from Contracts with Customers

. ***

The amendments contained in this appendix when this Standard was issued in 2014 have been incorporated into the text of the relevant Standards.

Appendix D

Amendments to HKFRS 9 *Financial Instruments*

The following sets out amendments required for this Standard resulting from amendments to HKFRS 9 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted.

Paragraph 7.1.7 is added. A new heading and paragraphs 7.2.29–7.2.34 are added.

Chapter 7 Effective date and transition

7.1 Effective date

...

- 7.1.7 *Prepayment Features with Negative Compensation* (Amendments to HKFRS 9), issued in November 2017, added paragraphs 7.2.29–7.2.34 and B4.1.12A and amended paragraphs B4.1.11(b) and B4.1.12(b). An entity shall apply these amendments for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.2 Transition

...

Transition for *Prepayment Features with Negative Compensation*

- 7.2.29 An entity shall apply *Prepayment Features with Negative Compensation* (Amendments to HKFRS 9) retrospectively in accordance with HKAS 8, except as specified in paragraphs 7.2.30–7.2.34.
- 7.2.30 An entity that first applies these amendments at the same time it first applies this Standard shall apply paragraphs 7.2.1–7.2.28 instead of paragraphs 7.2.31–7.2.34.
- 7.2.31 An entity that first applies these amendments after it first applies this Standard shall apply paragraphs 7.2.32–7.2.34. The entity shall also apply the other transition requirements in this Standard necessary for applying these amendments. For that purpose, references to the date of initial application shall be read as referring to the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments).
- 7.2.32 With regard to designating a financial asset or financial liability as measured at fair value through profit or loss, an entity:
- (a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.1.5 but that condition is no longer satisfied as a result of the application of these amendments;
 - (b) may designate a financial asset as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.1.5 but that condition is now satisfied as a result of the application of these amendments;
 - (c) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.2.2(a) but that condition is no longer satisfied as a result of the application of these amendments; and

- (d) may designate a financial liability as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.2.2(a) but that condition is now satisfied as a result of the application of these amendments.

Such a designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application of these amendments. That classification shall be applied retrospectively.

- 7.2.33 An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in this Standard. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.
- 7.2.34 In the reporting period that includes the date of initial application of these amendments, the entity shall disclose the following information as at that date of initial application for each class of financial assets and financial liabilities that were affected by these amendments:
 - (a) the previous measurement category and carrying amount determined immediately before applying these amendments;
 - (b) the new measurement category and carrying amount determined after applying these amendments;
 - (c) the carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated; and
 - (d) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

In Appendix B, paragraphs B4.1.11(b) and B4.1.12(b) are amended. Paragraph B4.1.12A is added. Paragraph B4.1.10 has not been amended but has been included for ease of reference. Deleted text is struck through.

Classification (Chapter 4)

Classification of financial assets (Section 4.1)

...

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

...

Contractual terms that change the timing or amount of contractual cash flows

B4.1.10 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph B4.1.18.)

B4.1.11 The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

- (a) a variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;
- (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable ~~additional~~ compensation for the early termination of the contract; and
- (c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

B4.1.12 Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:

- (a) the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
- (b) the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable ~~additional~~ compensation for the early termination of the contract; and
- (c) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

B4.1.12A For the purpose of applying paragraphs B4.1.11(b) and B4.1.12(b), irrespective of the event or circumstance that causes the early termination of the contract, a party may pay **or** receive reasonable compensation for that early termination. For example, a party may pay or receive reasonable compensation when it chooses to terminate the contract early (or otherwise causes the early termination to occur).

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 9 (2014)*

Financial Instruments



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Appendix B

Amendments to the Basis for Conclusions on other Standards

This appendix contains amendments to the Basis for Conclusions on other Standards that are necessary in order to ensure consistency with IFRS 9 and the related amendments to other Standards. These amendments incorporate with additions the amendments issued with IFRS 9 in 2009, 2010 and 2013. Consequently, if an entity has applied a previous version of IFRS 9, the amendments in this appendix replace the amendments that were issued with that previous version.

The amendments contained in this appendix when IFRS 9 was issued in 2014 have been incorporated into the Basis for Conclusions on the relevant Standards.

Appendix C

Basis for Conclusions on the amendments to IFRS 9 *Financial Instruments*

The following sets out amendments required for this Basis for Conclusions resulting from amendments to IFRS 9 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted.

A footnote is added at the end of paragraphs BC4.51 and BC5.233.

* In 2017 the IASB discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition of the financial liability. See paragraphs BC4.252–BC4.253.

After paragraph BC4.215, new headings and paragraphs BC4.216–BC4.253 are added.

Classification (Chapter 4)

...

Amendments for prepayment features with negative compensation (October 2017)¹

BC4.216 In 2016, the IFRS Interpretations Committee (Interpretations Committee) received a submission asking how particular prepayable financial assets would be classified applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower (ie the issuer) to prepay the instrument at an amount that could be more or less than unpaid amounts of principal and interest, such as at the instrument's current fair value or an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate.

BC4.217 As a result of such a contractual prepayment feature, the lender (ie the holder) could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. Such a prepayment amount would, in effect, include an amount that reflects a payment to the borrower from the lender, instead of compensation *from* the borrower to the lender, even though the borrower chose to prepay the debt instrument. An outcome in which the party choosing to terminate the contract receives an amount, instead of pays an amount, is inconsistent with paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, it is inconsistent with the notion of reasonable additional compensation for the early termination of the contract. In this section of the Basis for Conclusions, such an outcome is referred to as negative compensation. Thus, the financial assets described in the submission would not have contractual cash flows that are solely payments of principal and interest, and those instruments would be measured at fair value through profit or loss applying IFRS 9 (as issued in 2014).

¹ In this section, the discussion about amortised cost measurement is relevant to both financial assets in the amortised cost measurement category and financial assets in the fair value through other comprehensive income measurement category. That is because, for the latter, the assets are measured at fair value in the statement of financial position and amortised cost information is provided in profit or loss. A financial asset is measured at amortised cost or fair value through other comprehensive income only if both conditions in paragraph 4.1.2 or paragraph 4.1.2A of IFRS 9, respectively, are met. The amendments discussed in this section address only the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Accordingly, this section does not discuss the conditions in paragraphs 4.1.2(a) and 4.1.2A(a) relating to the business model but instead assumes that the asset is held in the relevant business model.

- BC4.218 Nevertheless, Interpretations Committee members suggested that the IASB consider whether amortised cost measurement could provide useful information about particular financial assets with prepayment features that may result in negative compensation, and if so, whether the requirements in IFRS 9 should be changed in this respect.
- BC4.219 In the light of the Interpretations Committee's recommendation and similar concerns raised by banks and their representative bodies in response to the Interpretations Committee's discussion, the IASB proposed amendments to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of a prepayment feature that may result in negative compensation. The Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) (2017 Negative Compensation Exposure Draft) proposed that such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are held, if two eligibility conditions are met.
- BC4.220 Most respondents to the 2017 Negative Compensation Exposure Draft agreed with the IASB's decision to address the classification of such prepayable financial assets, and highlighted the urgency of the issue given the proximity to the effective date of IFRS 9.
- BC4.221 In October 2017, the IASB amended IFRS 9 by issuing *Prepayment Features with Negative Compensation* (Amendments to IFRS 9), which confirmed with modifications the proposals in the 2017 Negative Compensation Exposure Draft. Specifically, in the amendments issued in October 2017, the IASB amended paragraphs B4.1.11(b) and B4.1.12(b), and added paragraph B4.1.12A of IFRS 9. As a result of those amendments, particular financial assets with prepayment features that may result in reasonable negative compensation for the early termination of the contract are eligible to be measured at amortised cost or at fair value through other comprehensive income.

The prepayment amount

- BC4.222 In developing the 2017 Negative Compensation Exposure Draft, the IASB noted that any proposal to measure at amortised cost financial assets with prepayment features that may result in negative compensation must be limited to those assets for which the effective interest method provides useful information to users of financial statements about the amount, timing and uncertainty of future cash flows. Accordingly, the first eligibility condition proposed in the Exposure Draft was intended to identify those prepayment features that do not introduce any contractual cash flow amounts that are different from the cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014).
- BC4.223 In the deliberations that led to that proposal, the IASB noted that paragraph B4.1.11(b) of IFRS 9 accommodates contractual terms that permit either the borrower or the lender to choose to terminate the contract early and compensate the other party for having to accept that choice. Accordingly, that paragraph already accommodates a prepayment amount that is more or less than unpaid amounts of principal and interest, depending on which party chooses to terminate the contract early. In applying the effective interest method to measure such financial assets at amortised cost, an entity considers the contractual cash flows arising from such a prepayment feature when it estimates the future cash flows and determines the effective interest rate at initial recognition. Subsequently, consistent with the treatment of all financial instruments measured at amortised cost, the entity applies paragraph B5.4.6 of IFRS 9 and adjusts the gross carrying amount of the financial asset if it revises its estimates of contractual cash flows, including any revisions related to the exercise of the prepayment feature.
- BC4.224 Similarly, for a financial asset with a prepayment feature that may result in negative compensation, the prepayment amount may be more or less than unpaid amounts of principal and interest. However, the difference is that such a prepayment feature may have the result that the party that triggers the early termination of the contract may, in effect, receive an amount *from* the other party, rather than pay compensation *to* the other party. To illustrate this difference, the IASB considered a loan with a prepayment feature that may result in negative compensation. Specifically, both the borrower and the lender have the option to terminate the loan before maturity and, if the loan is terminated early, the prepayment amount includes compensation that reflects the change in the relevant benchmark interest rate. That is, if the loan is terminated early (by either party) and the relevant benchmark interest rate has fallen since the loan was initially recognised, then the lender

will effectively receive an amount representing the present value of that lost interest revenue over the loan's remaining term. Conversely, if the contract is terminated early (by either party) and the relevant benchmark interest rate has risen, then the borrower will effectively receive an amount that represents the effect of that change in that interest rate over the loan's remaining term.

BC4.225 The IASB acknowledged that the contractual terms of the loan described in paragraph BC4.224 do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). That is, the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, the loan's prepayment amount reflects unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. The contractual terms of the loan described in paragraph BC4.224 change only the circumstances in which the compensation amounts may arise; ie the loan may result in either reasonable additional compensation or reasonable negative compensation for the early termination of the contract.

BC4.226 The IASB noted that from a computation standpoint, the effective interest method, and thus amortised cost measurement, could be applied to the contractual cash flows that arise from a prepayable financial asset like the loan described in paragraph BC4.224. As described in paragraph BC4.223, the entity would consider the prepayment feature when it estimates the future cash flows and determines the effective interest rate. Subsequently, the entity would apply paragraph B5.4.6 of IFRS 9 and make a catch-up adjustment if it revises its estimates of contractual cash flows, including any revisions related to the prepayment feature.

BC4.227 Furthermore, the IASB decided that amortised cost measurement could provide useful information to users of financial statements about financial assets whose prepayment amount is consistent with paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) in all respects except that the party that chooses to terminate the contract early may receive reasonable compensation for doing so. That is because, as discussed in paragraph BC4.225, such prepayment features do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014); ie the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Therefore, the 2017 Negative Compensation Exposure Draft proposed an eligibility condition that was intended to capture those prepayment features that would have been accommodated by paragraph B4.1.11(b) except that a party may receive reasonable compensation for the early termination of the contract even if it is the party that chooses to terminate the contract early (or otherwise causes the early termination to occur).

BC4.228 Nearly all respondents agreed with that eligibility condition proposed in the 2017 Negative Compensation Exposure Draft. Specifically, they agreed that reasonable negative compensation for the early termination of the contract should not in itself preclude amortised cost measurement. The respondents agreed with the IASB's rationale described in paragraphs BC4.226–BC4.227 and they also agreed that the proposed eligibility condition would capture a population of financial assets for which amortised cost measurement could provide useful information to users of financial statements. The respondents said that measuring such assets at amortised cost, and including them in key metrics like net interest margin, would provide useful information to users of financial statements about the financial assets' performance. Those respondents consider information about expected credit losses and interest revenue (calculated using the effective interest method) to be more relevant than information about changes in fair value for the purpose of assessing the performance and future cash flows of those financial assets.

BC4.229 Consequently, in its redeliberations of the 2017 Negative Compensation Exposure Draft, the IASB confirmed that proposed eligibility condition. As a result, applying the amendments, a financial asset with a prepayment feature that may result in negative compensation is eligible to be measured at amortised cost or fair value through other comprehensive income if it would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable *negative* compensation for the early termination of the contract.

BC4.230 However, one respondent said that the IASB had not addressed the case in which the early termination of the contract is caused by an event that is outside the control of both parties to the contract, such as a change in law or regulation. That respondent asked the IASB to clarify the amendments in that regard. The IASB agreed with that observation. Consequently, the wording in paragraph B4.1.12A of the amendments refers to the *event or circumstance* that caused the early termination of the contract. Such an event or circumstance may be within the control of one of the parties to the contract (for example, the borrower may choose to prepay) or it may be beyond the control of both parties (for example, a change in law may cause the contract to automatically terminate early).

Other prepayment amounts

BC4.231 As described in paragraph BC4.229, the IASB decided to limit the scope of the amendments to those financial assets with prepayment features that would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable negative compensation for the early termination of the contract. The IASB observed that the effective interest method, and thus amortised cost measurement, are not appropriate when the prepayment amount is inconsistent with that paragraph for any other reason.

BC4.232 As described in the submission to the Interpretations Committee, some financial assets are prepayable at their current fair value. The IASB is also aware that some financial assets are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument (which may or may not be in a hedging relationship with the prepayable financial asset for accounting purposes). Some interested parties suggested that both of those types of prepayable financial asset should be eligible for amortised cost measurement. The IASB acknowledged that there may be some circumstances in which such a contractual prepayment feature results in contractual cash flows that are solely payments of principal and interest in accordance with IFRS 9, as amended; ie there may be circumstances in which the compensation included in such a prepayment amount is reasonable for the early termination of the contract. For example, that may be the case when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. However, the Board observed that it will not always be the case and therefore an entity cannot presume that all such prepayable financial assets are eligible to be measured at amortised cost. Entities must assess an instrument's specific contractual cash flow characteristics.

The probability of prepayment

BC4.233 A prepayment feature that may result in negative compensation changes the circumstances, and increases the frequency, in which the contractual compensation amounts could arise. Accordingly, in the deliberations that led to the publication of the 2017 Negative Compensation Exposure Draft, the IASB observed that if such a prepayable financial asset is measured at amortised cost, the likelihood is higher that the lender will be required to make catch-up adjustments applying paragraph B5.4.6 of IFRS 9 to reflect revisions to its estimates of contractual cash flows related to the exercise of the prepayment feature. This could include adjustments to reflect circumstances in which the lender is forced to settle the contract in a way that it would not recover its investment for reasons other than the asset's credit quality. The IASB observed that recognising frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the objective of the effective interest method, which is a relatively simple measurement technique that allocates interest using the effective interest rate over the relevant time period. Recognising more frequent adjustments in the gross carrying amount could reduce the usefulness of the interest amounts that are calculated using such a simple measurement technique and could suggest that fair value measurement would provide more useful information.

BC4.234 Consequently, the IASB proposed a second eligibility condition in the 2017 Negative Compensation Exposure Draft. That eligibility condition would have required that the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. The objective of that proposed eligibility condition was to limit further the scope of the amendments so that financial assets would be eligible to be measured at amortised cost only if it is unlikely that prepayment, and thus negative compensation, would occur.

BC4.235 While some respondents agreed with that proposed eligibility condition, others disagreed and expressed concerns about matters such as how difficult the condition would be to apply, whether it would unduly restrict the scope of the amendments and whether it would achieve the IASB's stated objective. Most of the respondents that disagreed with the second eligibility condition said the first eligibility condition (discussed above in paragraphs BC4.222–BC4.232) was sufficient. They expressed the view that the requirements in paragraph B4.1.11(b) of IFRS 9 should accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie an entity should be required to assess negative compensation for the early termination of the contract in the same way as it assesses additional compensation for the early termination of the contract. Some respondents suggested alternatives that they thought would better achieve the IASB's objective. Those suggestions included assessing the probability that prepayment, or negative compensation, will occur.

BC4.236 During its redeliberations, the IASB observed that the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would, in some cases, achieve its objective. That is because the fair value of the prepayment feature would take into account the likelihood that prepayment will occur. Accordingly, if it is very unlikely that prepayment will occur, then the fair value of the prepayment feature will be insignificant. The IASB also reconfirmed its view that the scope of the amendments must be limited to financial assets for which the effective interest method, and thus amortised cost, can provide useful information, and observed that a second eligibility condition would be helpful to precisely identify the relevant population.

BC4.237 However, the IASB acknowledged the concerns expressed by respondents. The Board agreed with the concern that the fair value of a prepayment feature would reflect not only the probability that reasonable negative compensation will occur, but it would also reflect the probability that reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)) will occur. In some circumstances, the fair value of the prepayment feature may be more than insignificant due largely, or entirely, to the latter. In such circumstances, the financial asset would not meet the second eligibility condition even if the holder determined that it was very unlikely that negative compensation will occur.

BC4.238 The IASB also noted concerns that the fair value of the prepayment feature could be insignificant even if it is likely that negative compensation may occur. For example, that could be the case if the compensation structure of the prepayment feature is symmetrical so that the effect of reasonable negative compensation on that feature's fair value is offset by the effect of reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)), or if the prepayment amount is close to the instrument's fair value at the prepayment date.

BC4.239 Consequently, during its redeliberations, the IASB concluded that, in some circumstances, the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would not restrict the scope of the amendments in the way that the IASB intended and, in other circumstances, could restrict the scope in a way that the IASB did not intend. Therefore, on balance, the IASB decided not to confirm the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft.

BC4.240 The IASB noted that the alternatives to the second eligibility condition that were suggested by respondents were not discussed in the 2017 Negative Compensation Exposure Draft and therefore interested parties did not have the opportunity to provide feedback on them. Many respondents to that Exposure Draft highlighted the importance of finalising the amendments before the effective date of IFRS 9 and the IASB noted that prioritising such timing would preclude the Board from conducting outreach to assess those alternatives. Moreover, the IASB doubted whether those alternatives would better achieve its objective without introducing significant complexity to the amendments. Therefore, the IASB decided not to replace the second proposed eligibility condition with any of those alternatives.

Corresponding amendment to paragraph B4.1.12

BC4.241 As a consequence of its decisions to confirm the first proposed eligibility condition and remove the second proposed eligibility condition, the IASB observed that paragraph B4.1.11(b) of IFRS 9 will accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie entities will be required to assess all amounts of reasonable compensation for the early termination of the contract in the same way.

BC4.242 Accordingly, the IASB amended paragraph B4.1.12(b) of IFRS 9 to align it with paragraph B4.1.11(b). As a result, paragraph B4.1.12(b) also accommodates reasonable negative compensation for the early termination of the contract. The IASB decided that there was no compelling reason to treat the notion of reasonable compensation for the early termination of the contract in paragraph B4.1.12(b) of IFRS 9 differently from that notion in paragraph B4.1.11(b).

Effective date

BC4.243 The 2017 Negative Compensation Exposure Draft proposed that the effective date of the amendments would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018, with earlier application permitted.

BC4.244 Some respondents agreed with that proposal and said there would be significant benefits if entities take into account the effect of the amendments when they initially apply IFRS 9. In contrast, others preferred a later effective date for the amendments; specifically, annual periods beginning on or after 1 January 2019 (with earlier application permitted). These respondents observed that many entities are advanced in their implementation of IFRS 9 and may not have sufficient time before the effective date of IFRS 9 to determine the effect of these amendments. Additionally, some jurisdictions will need time for translation and endorsement activities and the proposed effective date may not provide them with sufficient time for those activities.

BC4.245 In the light of the feedback received, the IASB decided to require that entities apply the amendments for annual periods beginning on or after 1 January 2019, with earlier application permitted. This alleviates the concerns about the timing of these amendments while also permitting an entity to apply the amendments and IFRS 9 at the same time if it is in a position to do so.

Transition

Entities that initially apply the amendments and IFRS 9 at the same time

BC4.246 As described in paragraph BC4.245, an entity is permitted to apply the amendments earlier than the mandatory effective date and, as a result, can take into account the effect of the amendments when it initially applies IFRS 9. In such cases, an entity would apply the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) to all financial assets and financial liabilities within the scope of that Standard. No specific transition provisions are needed for the amendments.

Entities that initially apply the amendments after previously applying IFRS 9

BC4.247 Some entities will apply the amendments after they have already applied IFRS 9. The IASB considered whether specific transition requirements are needed for those entities because, without such additional transition requirements, the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) would not be applicable. That is because, as set out in paragraph 7.2.27 of IFRS 9, an entity applies each of the transition provisions in IFRS 9 only once; ie at the relevant date of initial application of IFRS 9. This means that entities would be required to apply the amendments retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, in some circumstances, an entity may not be able to apply the amendments retrospectively without the use of hindsight. When the IASB developed the transition requirements in IFRS 9, it provided requirements to address scenarios when it would be impracticable to apply particular requirements retrospectively. Accordingly, the IASB decided to provide transition requirements for entities that apply the amendments after they have already applied IFRS 9.

BC4.248 Consistent with the existing transition requirements in IFRS 9 for assessing whether the contractual terms of a financial asset give rise to cash flows that are solely payments of principal and interest, the amendments must be applied retrospectively. To do so, an entity applies the relevant transition provisions in IFRS 9 necessary for applying the amendments. For example, an entity applies the transition requirements in paragraph 7.2.11 related to the effective interest method and paragraphs 7.2.17–7.2.20 related to the impairment requirements to a financial asset that is newly measured at amortised cost or fair value through other comprehensive income as a result of applying the amendments.

BC4.249 The IASB provided specific transition provisions related to the fair value option because an entity may change the classification and measurement of some financial assets as a result of applying the amendments. Therefore, an entity is permitted to newly designate, and is required to revoke its previous designation of, a financial asset or a financial liability at the date of initial application of the amendments only to the extent that a new accounting mismatch is created, or a previous accounting mismatch no longer exists, as a result of applying the amendments.

BC4.250 Finally, the IASB decided that an entity is not required to restate prior periods to reflect the effect of the amendments, and could choose to do so only if such restatement is possible without the use of hindsight and if the restated financial statements reflect all the requirements in IFRS 9. This decision is consistent with the transition requirements in IFRS 9.

BC4.251 In addition to any disclosures required by other IFRS Standards, the IASB required disclosures that would provide information to users of financial statements about changes in the classification and measurement of financial instruments as a result of applying the amendments. These disclosures are similar to the disclosures in paragraphs 42I–42J of IFRS 7, which are required when an entity initially applies IFRS 9.

Another issue

Modification or exchange of a financial liability that does not result in derecognition

BC4.252 Concurrent with the development of the amendments to IFRS 9 for prepayment features with negative compensation, the IASB also discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. More specifically, at the request of the Interpretations Committee, the Board discussed whether, applying IFRS 9, an entity recognises any adjustment to the amortised cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification or exchange.

BC4.253 The IASB decided that standard-setting is not required because the requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. In doing so, the Board highlighted that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in the derecognition of the financial liability are consistent with the requirements for adjusting the gross carrying amount of a financial asset when a modification does not result in the derecognition of the financial asset.

Implementation Guidance

Hong Kong Financial Reporting Standard 9 (2014)

Financial Instruments



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LCX200), Entity A recognises only LCX25 (= LCY10 × 2.5) of this increase in consolidated profit or loss to comply with paragraph 39(b) of IAS 21. The resulting exchange difference, ie the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 = LCX105), is accumulated in other comprehensive income until the disposal of the net investment in the foreign operation in accordance with paragraph 48 of IAS 21.

E.3.4 IFRS 9 and IAS 21—interaction between IFRS 9 and IAS 21

IFRS 9 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in profit or loss. IAS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in profit or loss. In what order are IAS 21 and IFRS 9 applied?

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IFRS 9. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9). For example, if a monetary financial asset (such as a debt instrument) is measured at amortised cost in accordance with IFRS 9, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (paragraph 23 of IAS 21). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (paragraph 24 of IAS 21). A non-monetary financial asset (such as an investment in an equity instrument) that is measured at fair value in the foreign currency is translated using the closing rate (paragraph 23 (c) of IAS 21).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IFRS 9 (or IAS 39 if an entity chooses as its accounting policy to continue to apply the hedge accounting requirements in IAS 39), the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under IAS 21 (paragraph 6.5.8 of IFRS 9 or paragraph 89 of IAS 39), ie the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (paragraph 23(b) of IAS 21).

Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising a *monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in profit or loss in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9, paragraphs 28 and 32 of IAS 21), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges apply (paragraph 6.5.11 of IFRS 9 or paragraph 95 of IAS 39). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognised in profit or loss in accordance with IFRS 9. For example, although an entity recognises gains and losses on financial assets measured at fair value through other comprehensive income in other comprehensive income (paragraphs 5.7.10 and B5.7.2A of IFRS 9), the entity nevertheless

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 10*

Consolidated Financial Statements



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investments under the control of venture capital organisations, private equity entities and similar organisations, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control.

- BC217 The scope of the proposals in ED 10 was the same as the scope of the proposals in IAS 27. IAS 27 required reporting entities to consolidate all controlled entities, regardless of the nature of the reporting entity. Respondents to ED 10 questioned the usefulness of financial statements of investment entities that consolidate investees that the investment entity controls. They pointed out that some national accounting requirements, including United States Generally Accepted Accounting Principles (US GAAP), have historically provided industry-specific guidance that requires investment entities to measure all of their investments, including those that they control, at fair value. The respondents argued that an investment entity holds investments for the sole purpose of capital appreciation, investment income (such as dividends or interest), or both. Users of the financial statements of these investment entities told the Board that the fair value of the investments and an understanding of how the investment entity measures the fair value of its investments is the most useful information.
- BC218 Furthermore, respondents to ED 10 argued that consolidated financial statements of an investment entity may hinder users' ability to assess an investment entity's financial position and results, because it emphasizes the financial position, operations and cash flows of the investee, rather than those of the investment entity. Often, an investment entity holds non-controlling interests in some entities that are reported at fair value, as well as controlling interests in other entities that are consolidated in accordance with current principles in IFRSs. Reporting investments on more than one basis hinders comparability within the financial statements, because all investments are held by an investment entity for a similar purpose—returns from capital appreciation, investment income, or both. In addition, some of the items consolidated may be measured at historical cost, which distorts the performance assessment of the investment entity and does not reflect the way in which the business of the entity is managed.
- BC219 Respondents to ED 10 also argued that when an investment entity consolidates entities that it controls, it is not required to provide the disclosures related to fair value measurements that would be required if the subsidiaries were measured at fair value. For example, IFRS 7 relates only to recognised financial assets and liabilities. There is no requirement to provide disclosures related to fair value for investments in consolidated subsidiaries. Information about fair value and the methodology and inputs used for determining fair value is vital for users to make investment decisions about investment entities. Investors in an investment entity are interested in the fair value of their interest in that entity and often transact with it on a fair value basis (ie their investment in the investment entity is based on a share of the net assets of that entity). Reporting the fair value of substantially all of the net assets of an investment entity allows the investors in that entity to more easily identify the value of their share of those net assets.
- BC220 In response to this feedback, the Board published an Exposure Draft *Investment Entities (Investment Entities ED)* in August 2011. The *Investment Entities ED* proposed that investment entities would be required to measure their investments in subsidiaries (except those subsidiaries that provide investment-related services) at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (or IAS 39,[#] if IFRS 9 has not yet been adopted).^{*} The majority of respondents to the *Investment Entities ED* broadly supported the proposed exception to consolidation for the reasons outlined in paragraphs BC217–BC219.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} In December 2014, the Board issued *Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)*. These amendments clarified which subsidiaries of an investment entity are consolidated in accordance with paragraph 32 of IFRS 10, instead of being measured at fair value through profit or loss (see paragraphs BC240A–BC240I).

BC221 The Board conducted its deliberations leading to the publication of the *Investment Entities* ED and the final investment entities requirements jointly with the FASB. The similarities and differences between the investment entities guidance in IFRS and US GAAP are discussed further in paragraphs BC289–BC291.

Scope of the project

BC222 The *Investment Entities* ED proposed a limited-scope exception to consolidation for investment entities. A number of respondents to the *Investment Entities* ED asked the Board to expand the scope of its proposals.

BC223 Some respondents asked the Board to expand the scope of the project to require an investment entity to measure all of its investments at fair value. However, the Board noted that, in most cases, existing IFRSs require or permit investments held by an investment entity to be measured at fair value. For example an entity:

- (a) may elect the fair value option in IAS 40 *Investment Property*; and
- (b) would be required to measure its financial assets at fair value through profit or loss in accordance with IFRS 9 (or IAS 39*) when those assets are managed on a fair value basis.

Consequently, the Board decided to limit the scope of the project to only providing an exception to consolidation for investment entities.

BC224 Other respondents requested an extension of the proposed exception to consolidation. In particular, respondents from the insurance industry requested an exception to consolidating their interests in insurance investment funds. They argued that presenting the fair value of their interests in insurance investment funds as a single line item, along with a single line item for the current value of their liability to policyholders who receive the returns from those investment funds, would provide more useful information to users than consolidation. The Board noted that providing an exception to consolidation for insurers' interests in insurance investment funds is outside the scope of the *Investment Entities* project, which was meant to provide an exception to consolidation for investment entities. In addition, any additional exceptions to consolidation would require the Board to do further work to define the entities that could apply those exceptions. The Board noted that this additional exception to consolidation was not contemplated in the scope of the project nor was it exposed for comment. Consequently, the Board decided not to extend the proposed exception to consolidation.

BC225 Other respondents asked the Board to provide guidance permitting an investor in an investment entity to use the reported net asset value (NAV) per share of that investment entity as a practical expedient for measuring the fair value of its investment in that investment entity. Similar guidance exists in US GAAP. The Board considered providing such a practical expedient in their deliberations on IFRS 13 but decided against it because, at the time, there was no specific accounting guidance for investment entities in IFRS and because there are different practices for calculating NAVs in jurisdictions around the world. The Board decided that it is outside the scope of the *Investment Entities* project to provide fair value measurement guidance for investments in investment entities. The Board developed the definition of an investment entity to identify which entities should qualify for an exception to consolidation. The definition was not designed to decide which entities should qualify for a fair value measurement practical expedient. Moreover, the Board still has concerns that NAV could be calculated differently in different jurisdictions. Consequently, the Board decided not to provide an NAV practical expedient for fair value measurement as part of the *Investment Entities* project.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

existence does not necessarily mean that the investment entity is receiving any returns beyond solely capital appreciation, investment income, or both.

Exit strategy

- BC244 The Board believes that a parent with operating subsidiaries often plans to own and operate its subsidiaries indefinitely to realise returns from those operations. However, the Board does not think that an entity that holds its investments indefinitely, especially its subsidiaries, should qualify as an investment entity. Accordingly, the Board considered requiring an exit strategy for substantially all investments held by an investment entity, including debt investments.
- BC245 However, respondents to the *Investment Entities* ED noted that some investment funds that would otherwise qualify as investment entities may hold a significant amount of debt investments to maturity and therefore would not have an exit strategy for those debt investments. For example, the Board understands that, in some cases, private equity funds may make both debt and equity investments in their investees. The debt investments may have shorter maturities than the anticipated term of the fund's equity investment and may be held to maturity. Moreover, an investment entity may hold debt instruments to maturity to manage liquidity risk or to mitigate the risk from holding other types of more volatile investments. Although the entity does not have an exit strategy for these debt investments, it does not plan to hold them indefinitely—even if the entity does not plan to sell these investments before maturity, the vast majority of debt investments have a limited life.
- BC246 The Board decided that such an entity should not be prohibited from qualifying as an investment entity, provided that substantially all of its investments (including debt investments) are measured at fair value. The Board noted that debt investments may be measured at fair value in accordance with IFRS 9 or IAS 39* even in the absence of an exit strategy.
- BC247 However, the Board decided that an investment entity must have an exit strategy for substantially all of its investments that can be held indefinitely (typically equity investments and non-financial assets). The Board does not think it is appropriate for an entity to qualify for an exception to consolidation if that entity is holding equity investments indefinitely and is not planning to realise capital appreciation from those investments. Although the exit strategy may vary depending on circumstances, potential exit strategies that include a substantive time frame for exiting from the investment should still be identified and documented for equity and non-financial investments in order to meet the definition of an investment entity.
- BC248 The Board noted that an entity may fail to meet this component of the definition of an investment entity if it is formed in connection with an investment entity investee for legal, regulatory, tax or similar business reasons (eg a 'blocker' entity or a 'master-feeder' structure), and that that investee holds investments on behalf of the entity. The Board decided that the entity should not be prohibited from qualifying as an investment entity merely because it does not have an exit strategy for the investee, if that investee qualifies as an investment entity and has appropriate exit strategies for its own investments.

Fair value measurement

- BC249 In the development of IFRS 10 and the *Investment Entities* ED, the Board heard that fair value information is the primary driver of the decision-making processes both of the management of, and the investors in, investment entities. Many respondents stated that both management and investors evaluate the performance of an investment entity by reference to the fair value of its investments. The Board heard

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

that some investors in investment entities disregard the consolidated financial statements of investment entities and instead rely on non-GAAP fair value reports.

BC250 The basis for the exception to consolidation that is provided to investment entities is that fair value information is the most relevant for an investment entity's investments, including its investments in subsidiaries. The Board therefore decided that an essential feature of the definition of an investment entity is that the entity would use existing IFRS requirements or accounting policy options to measure substantially all of its investments at fair value. The Board does not think that an entity that fails to elect the fair value measurement options available in IAS 28 *Investments in Associates and Joint Ventures* or IAS 40, or that accounts for more than an insignificant amount of its financial assets at amortised cost under IFRS 9 or IAS 39,* should qualify as an investment entity.

BC251 The Board noted that some investments may be measured at fair value in the statement of financial position, with fair value changes recognised in other comprehensive income rather than through profit or loss, and agreed that this would satisfy the fair value measurement element of the definition of an investment entity.

BC252 The Board considers that a significant distinguishing characteristic of an investment entity is that investors in an investment entity are primarily interested in fair value and make their investing decisions based on the fair value of the investment entity's underlying investments. The Board notes that this is partly because, in many cases, investors in an investment entity transact with it on a fair value basis (for example, on the basis of a net asset value per share, which is calculated using the fair value of the entity's underlying investments). Similarly, the Board believes that fair value should also be used by an investment entity's key management personnel to assess the entity's performance and to make investing decisions. Consequently, the Board decided that, in order to meet the definition of an investment entity, an entity should demonstrate that fair value is the primary measurement attribute used to evaluate the performance of its investments, both internally and externally.

Regulatory requirements

BC253 The Board considered whether to include a reference to regulatory requirements in the definition of an investment entity. The Board noted that the FASB proposed, in their own Exposure Draft, that any entity that was regulated as an investment company under the US Securities and Exchange Commission's Investment Company Act of 1940 would automatically be considered to be an investment company for US GAAP financial reporting purposes. Some respondents to the Board's *Investment Entities* ED also asked the Board to include a reference to regulatory requirements in the definition of an investment entity, which would allow any entity regulated as an investment entity to fall within the scope of the investment entity requirements.

BC254 However, the Board was concerned that:

- (a) the regulatory requirements in different jurisdictions may result in similar entities qualifying as an investment entity in one jurisdiction but not in another;
- (b) regulatory requirements may change over time, resulting in an ever-changing population of entities that would be eligible for an exception to consolidation; and
- (c) it would have no control over which entities would qualify for the exception to consolidation.

Consequently, the Board decided not to reference regulatory requirements in the definition of an investment entity.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC281 In addition, the Board considered the practical difficulties in retaining the exception to consolidation when a non-investment entity parent and an investment entity subsidiary invest in the same investment or when an investment entity subsidiary holds a subsidiary that invests in the equity of a non-investment entity parent.
- BC282 The Board noted that the retention of the specialised accounting used by an investment company subsidiary at a non-investment company level is a long-standing requirement in US GAAP. However, US GAAP has industry-specific guidance for a number of industries, and the application of that industry-specific guidance by a subsidiary is retained by a parent entity, regardless of whether the parent entity is part of that industry. IFRSs generally do not contain such industry-specific guidance.
- BC283 Some respondents to the *Investment Entities* ED noted that not retaining the fair value accounting of an investment entity subsidiary in its non-investment entity parent's financial statements seems inconsistent with IAS 28 *Investments in Associates and Joint Ventures*. IAS 28 allows a parent that indirectly holds an investment in an associate through a venture capital organisation, mutual fund, unit trust or similar entity to measure that portion of the investment at fair value through profit or loss in accordance with IFRS 9 or IAS 39.* The Board acknowledged the inconsistency but thought it was important to keep the retention of fair value accounting that is currently allowed for venture capital organisations, mutual funds, unit trusts and similar entities. The Board also noted that the difference between using the equity method and fair value measurement for investments in associates and joint ventures is smaller than that between consolidation and fair value measurement for investments in subsidiaries.

Transition

- BC284 The Board proposed in the *Investment Entities* ED that the exception to consolidation should be applied prospectively. Some respondents disagreed with the proposal, arguing that retrospective application would result in more useful information. In addition, they noted that retrospective application should not be onerous because investment entities would be expected to have information about the fair value of their investments. Those respondents also argued that retrospective application would be consistent with the other transition requirements in IFRS 10.
- BC285 The Board agreed with these arguments and decided to require retrospective application of the exception to consolidation, subject to specific transition reliefs, such as:
- (a) a relief for when it is impracticable to identify the fair value of investments;
 - (b) a relief for when an investment entity disposes of investments prior to the date of initial application; and
 - (c) a relief from providing comparative information for more than one period preceding the date of initial application.
- BC286 The Board also noted that entities that adopt these amendments early may not have adopted IFRS 13, which has an effective date of 1 January 2013. Consequently, the Board decided that when an investment entity has not yet adopted IFRS 13, it may use the fair value amounts previously reported to investors or to management, as long as those amounts represent the amount for which the investment could have been exchanged between knowledgeable, willing parties in an arm's length transaction at the date of the valuation. The Board noted that if previously used fair value measurements are not available, it may be impracticable to measure fair value without using hindsight. In such cases, transition relief is available.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

BC287 The Board also decided to require first-time adopters to apply the requirements retrospectively, subject to specific transition reliefs.*

BC287A The Board decided that no specific transition guidance was needed and, therefore, an entity should apply *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28) retrospectively in accordance with IAS 8. However, the Board decided that an entity need only present the quantitative information required by paragraph 28(f) of IAS 8 for the annual period immediately preceding the date of initial application of this IFRS (the 'immediately preceding period') when the amendments are first applied.

Effective date and early application

BC288 The Board decided on a 1 January 2014 effective date for the requirements for investment entities. The Board noted that because these requirements provide an exception to consolidation, they should have the same effective date as the revised consolidation requirements in IFRS 10 (annual periods beginning on or after 1 January 2013). However, given that the investment entities requirements were published in October 2012, the Board did not believe that a 1 January 2013 effective date would give adequate time for implementation between the publication and effective dates. However, the Board decided to permit early application of the investment entity requirements. The Board noted that it expects many entities to apply the requirements early. Some investments in subsidiaries may not have been consolidated in accordance with IAS 27 and SIC-12 but, without the exception to consolidation, would need to be consolidated in accordance with IFRS 10. The Board noted that it would be potentially confusing to users of financial statements and time-consuming for the investment entity to consolidate a subsidiary in one accounting period and then carry the same investee at fair value in the following period. In addition, investment entities should already have the fair value information needed for implementation. Finally, the exception to consolidation has been a long-standing request from the investment entity industry. Consequently, the Board believes that many investment entities will want to adopt the requirements early.

Joint deliberations with the FASB

BC289 The Board deliberated this project jointly with the FASB. US GAAP has had comprehensive accounting guidance for investment companies for many years (contained in Topic 946 *Investment Companies*). By deliberating this project jointly, the boards hoped to achieve as similar guidance as possible. To that end, they came up with similar definitions of investment entities and guidance on how to assess investment entity status.

BC290 However, the scope of the project was different for the IASB and the FASB. The IASB's Investment Entities project started during the deliberations on the Consolidations project and was only intended to provide an exception to consolidation for investment entities. The FASB was seeking to improve and converge the definition of an investment company with that of the IASB because it already has comprehensive accounting and reporting guidance for investment companies.

* Annual improvements to IFRS Standards 2014-2016 Cycle, issued in December 2016, amended IFRS 1 First-time Adoption of International Financial Reporting Standards by deleting the short-term exemption for first-time adopters (see paragraph BC99 of IFRS 1), because it was no longer applicable.

BC296 The exception to consolidation will change the way in which an investment entity parent reports its interest in an entity that it controls. Rather than consolidating its subsidiaries, an investment entity is now required to recognise a subsidiary as a single-line investment measured at fair value through profit or loss in accordance with IFRS 9 (or IAS 39,* if IFRS 9 has not yet been adopted).

BC297 Accordingly, the exception to consolidation will affect investment entities that hold, as investments, controlling interests in other entities. However, although the changes are important to those entities affected, the changes are only expected to affect a narrow range of entities. Only those entities that meet the definition of an investment entity and hold controlling interests in other entities will be affected by these changes.

BC298 The entities most likely to be affected are:

- (a) private equity or venture capital funds; these have business models in which it is more likely that it would be beneficial to take a larger interest in a company, or control investees through debt and equity investment.
- (b) master-feeder or fund-of-funds structures where an investment entity parent has controlling interests in investment entity subsidiaries.

BC299 Some pension funds and sovereign wealth funds may also be affected; these may meet the definition of an investment entity and may also hold controlling investments in other entities.

BC300 Other types of entities may meet the definition of an investment entity, such as mutual funds and other regulated investment funds, but are less likely to hold controlling investments in other entities. Instead, they tend to hold lower levels of investments in a wider range of entities. Consequently, the exception to consolidation is less likely to affect these entities.

Comparability

BC301 An investment entity's control of an investee may change from one reporting period to the next. Without the exception to consolidation, an investment entity could be required to consolidate an investment in one period and present it as an investment measured at fair value through profit or loss in the following period (or vice versa). This would reduce comparability between reporting periods. With the introduction of the exception to consolidation, an investment entity can report all investments at fair value, regardless of whether those investments are controlled. This will improve the comparability between reporting periods.

BC302 Many respondents to ED 10 and the *Investment Entities* ED pointed out that some national accounting requirements, including US GAAP, have historically had industry-specific guidance that requires investment entities to measure investments that they control at fair value. Some of these respondents argued that investment entities were actively choosing to adopt those national accounting requirements rather than IFRS so that they could measure all of their investments at fair value. Respondents also pointed out that some investment entities that followed IFRS provided non-GAAP information about the fair value of all of their investments. Consequently, comparability of the financial statements of different investment entities was hindered. The Board expects the introduction of the exception to consolidation to encourage adoption of IFRS among investment entities and to eliminate the need to provide non-GAAP information about fair value. This should improve the comparability of financial statements of different investment entities.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

HKFRS 12
Revised November 2017 September 2018

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Financial Reporting Standard 12

Disclosure of Interests in Other Entities



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- (c) it is an agent or a principal (see paragraphs B58–B72 of HKFRS 10).
- (d) it does not have significant influence even though it holds 20 per cent or more of the voting rights of another entity.
- (e) it has significant influence even though it holds less than 20 per cent of the voting rights of another entity.

Investment entity status

- 9A** When a parent determines that it is an investment entity in accordance with paragraph 27 of HKFRS 10, the investment entity shall disclose information about significant judgements and assumptions it has made in determining that it is an investment entity. If the investment entity does not have one or more of the typical characteristics of an investment entity (see paragraph 28 of HKFRS 10), it shall disclose its reasons for concluding that it is nevertheless an investment entity.
- 9B** When an entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including:
- (a) the total fair value, as of the date of change of status, of the subsidiaries that cease to be consolidated;
 - (b) the total gain or loss, if any, calculated in accordance with paragraph B101 of HKFRS 10; and
 - (c) the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

Interests in subsidiaries

- 10** An entity shall disclose information that enables users of its consolidated financial statements
- (a) to understand:
 - (i) the composition of the group; and
 - (ii) the interest that non-controlling interests have in the group's activities and cash flows (paragraph 12); and
 - (b) to evaluate:
 - (i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group (paragraph 13);
 - (ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities (paragraphs 14–17);
 - (iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control (paragraph 18); and

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 12*

Disclosure of Interests in Other Entities



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Fair value of investments in joint ventures for which there are published price quotations

- BC61 IAS 28 required an entity to disclose the fair value of investments in associates for which published price quotations were available. Such quotations might also be available for joint ventures. Consequently, the Board decided to align this disclosure requirement by requiring an entity to disclose the fair value of investments in joint ventures for which there are published price quotations.

Investment entities

- BC61A *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27) introduced a requirement for investment entities to measure their investments in particular subsidiaries at fair value through profit or loss instead of consolidating them. The Board also decided on specific disclosure requirements for investment entities.

- BC61B In deciding on the appropriate disclosure requirements for investment entities, the Board noted that investment entities would be required to make the disclosures already contained in other Standards. In particular, the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, IFRS 13 *Fair Value Measurement* and IAS 24 *Related Party Disclosures* are likely to be relevant for users of investment entity financial statements.

- BC61C Users told the Board that disclosures relating to the valuation methodology used for measuring fair value and the underlying inputs are essential to their analyses. This information is already required by IFRS 7 and by IFRS 13 when reporting investments at fair value through profit or loss or other comprehensive income in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*.^{*} Accordingly, the Board decided that it was not necessary to propose any additional disclosure requirements relating to the fair value measurements made by investment entities.

- BC61D In the Exposure Draft *Investment Entities* (the *Investment Entities* ED), the Board proposed that an investment entity would be required to meet a disclosure objective that addressed all of an investment entity's investing activities. The *Investment Entities* ED also gave a number of examples of ways in which an investment entity could meet that disclosure objective. Respondents generally supported the disclosure guidance. However, the Board noted that it was outside the scope of the Investment Entities project to require all investment entities to provide disclosures about their investing activities. Consequently, the Board decided to remove the disclosure objective and the examples on how to meet the objective from the final requirements. Because the Investment Entities project focuses on providing an exception to consolidation, the Board decided to limit additional disclosures to information about unconsolidated subsidiaries.

- BC61E The Board also decided to require an investment entity to disclose the fact that it has applied the exception to consolidation, noting that such a disclosure would represent useful information. Moreover, the Board decided to require an investment entity to disclose when it does not display one or more of the typical characteristics of an investment entity, along with a justification of why it still meets the definition of an investment entity.

^{*} IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

HKFRS 13
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Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Financial Reporting Standard 13

Fair Value Measurement



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APPENDIX

Amendments to the guidance on other HKFRSs

Hong Kong Financial Reporting Standard 13 *Fair Value Measurement* (HKFRS 13) is set out in paragraphs 1–99 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 13 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Overview

- IN1 Hong Kong Financial Reporting Standard 13 *Fair Value Measurement* (HKFRS 13):
- (a) defines fair value;
 - (b) sets out in a single HKFRS a framework for measuring fair value; and
 - (c) requires disclosures about fair value measurements.
- IN2 The HKFRS applies to HKFRSs that require or permit fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except in specified circumstances.
- IN3 The HKFRS is to be applied for annual periods beginning on or after 1 January 2013. Earlier application is permitted.
- IN4 The HKFRS explains how to measure fair value for financial reporting. It does not require fair value measurements in addition to those already required or permitted by other HKFRSs and is not intended to establish valuation standards or affect valuation practices outside financial reporting.

Reasons for issuing the HKFRS

- IN5 Some HKFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. Because those HKFRSs were developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements were dispersed and in many cases did not articulate a clear measurement or disclosure objective.
- IN6 As a result, some of those HKFRSs contained limited guidance about how to measure fair value, whereas others contained extensive guidance and that guidance was not always consistent across those HKFRSs that refer to fair value. Inconsistencies in the requirements for measuring fair value and for disclosing information about fair value measurements have contributed to diversity in practice and have reduced the comparability of information reported in financial statements. HKFRS 13 remedies that situation.
- IN7 Furthermore, in 2006 the International Accounting Standards Board (IASB) and the US national standard-setter, the Financial Accounting Standards Board (FASB), published a Memorandum of Understanding, which has served as the foundation of the boards' efforts to create a common set of high quality global accounting standards. Consistent with the Memorandum of Understanding and the boards' commitment to achieving that goal, IFRS 13 (that is, the international equivalent of HKFRS 13) is the result of the work by the IASB and the FASB to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with IFRSs and US generally accepted accounting principles (GAAP).

Main features

- IN8 HKFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price).
- IN9 That definition of fair value emphasises that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

- IN10 The HKFRS explains that a fair value measurement requires an entity to determine the following:
- (a) the particular asset or liability being measured;
 - (b) for a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis;
 - (c) the market in which an orderly transaction would take place for the asset or liability; and
 - (d) the appropriate valuation technique(s) to use when measuring fair value. The valuation technique(s) used should maximise the use of relevant observable inputs and minimise unobservable inputs. Those inputs should be consistent with the inputs a market participant would use when pricing the asset or liability.

Hong Kong Financial Reporting Standard 13

Fair Value Measurement

Objective

- 1 This HKFRS:
 - (a) defines *fair value*;
 - (b) sets out in a single HKFRS a framework for measuring fair value; and
 - (c) requires disclosures about fair value measurements.
- 2 Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an *orderly transaction* to sell the asset or to transfer the liability would take place between *market participants* at the measurement date under current market conditions (ie an *exit price* at the measurement date from the perspective of a market participant that holds the asset or owes the liability).
- 3 When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximises the use of relevant *observable inputs* and minimises the use of *unobservable inputs*. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.
- 4 The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. In addition, this HKFRS shall be applied to an entity's own equity instruments measured at fair value.

Scope

- 5 This HKFRS applies when another HKFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except as specified in paragraphs 6 and 7.
- 6 The measurement and disclosure requirements of this HKFRS do not apply to the following:
 - (a) share-based payment transactions within the scope of HKFRS 2 *Share-based Payment*;
 - (b) leasing transactions within the scope of HKAS 17 *Leases*; and
 - (c) measurements that have some similarities to fair value but are not fair value, such as net realisable value in HKAS 2 *Inventories* or value in use in HKAS 36 *Impairment of Assets*.
- 7 The disclosures required by this HKFRS are not required for the following:
 - (a) plan assets measured at fair value in accordance with HKAS 19 *Employee Benefits*;
 - (b) retirement benefit plan investments measured at fair value in accordance with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans*; and

- (c) assets for which recoverable amount is fair value less costs of disposal in accordance with HKAS 36.
- 8 The fair value measurement framework described in this HKFRS applies to both initial and subsequent measurement if fair value is required or permitted by other HKFRSs.

Measurement

Definition of fair value

- 9 **This HKFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.**
- 10 Paragraph B2 describes the overall fair value measurement approach.

The asset or liability

- 11 **A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:**
- (a) the condition and location of the asset; and
 - (b) restrictions, if any, on the sale or use of the asset.
- 12 The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants.
- 13 The asset or liability measured at fair value might be either of the following:
- (a) a stand-alone asset or liability (eg a financial instrument or a non-financial asset); or
 - (b) a group of assets, a group of liabilities or a group of assets and liabilities (eg a cash-generating unit or a business).
- 14 Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purposes depends on its *unit of account*. The unit of account for the asset or liability shall be determined in accordance with the HKFRS that requires or permits the fair value measurement, except as provided in this HKFRS.

The transaction

- 15 **A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.**
- 16 **A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:**
- (a) in the *principal market* for the asset or liability; or
 - (b) in the absence of a principal market, in the *most advantageous market* for the asset or liability.
- 17 An entity need not undertake an exhaustive search of all possible markets to identify the principal market or, in the absence of a principal market, the most advantageous market, but it shall take into account all information that is reasonably available. In the absence of evidence to the contrary, the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the

principal market or, in the absence of a principal market, the most advantageous market.

- 18 If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or estimated using another valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.
- 19 The entity must have access to the principal (or most advantageous) market at the measurement date. Because different entities (and businesses within those entities) with different activities may have access to different markets, the principal (or most advantageous) market for the same asset or liability might be different for different entities (and businesses within those entities). Therefore, the principal (or most advantageous) market (and thus, market participants) shall be considered from the perspective of the entity, thereby allowing for differences between and among entities with different activities.
- 20 Although an entity must be able to access the market, the entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market.
- 21 Even when there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement shall assume that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability.

Market participants

- 22 **An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.**

- 23 In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to all the following:
- (a) the asset or liability;
 - (b) the principal (or most advantageous) market for the asset or liability; and
 - (c) market participants with whom the entity would enter into a transaction in that market.

The price

- 24 **Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.**
- 25 The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for *transaction costs*. Transaction costs shall be accounted for in accordance with other HKFRSs. Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.
- 26 Transaction costs do not include *transport costs*. If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

Application to non-financial assets

Highest and best use for non-financial assets

- 27 **A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its *highest and best use* or by selling it to another market participant that would use the asset in its highest and best use.**
- 28 The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:
- (a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).
 - (b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

- (c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.
- 29 Highest and best use is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.
- 30 To protect its competitive position, or for other reasons, an entity may intend not to use an acquired non-financial asset actively or it may intend not to use the asset according to its highest and best use. For example, that might be the case for an acquired intangible asset that the entity plans to use defensively by preventing others from using it. Nevertheless, the entity shall measure the fair value of a non-financial asset assuming its highest and best use by market participants.

Valuation premise for non-financial assets

- 31 The highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset, as follows:
- (a) The highest and best use of a non-financial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (eg a business).
 - (i) If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (ie its complementary assets and the associated liabilities) would be available to market participants.
 - (ii) Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.
 - (iii) Assumptions about the highest and best use of a non-financial asset shall be consistent for all the assets (for which highest and best use is relevant) of the group of assets or the group of assets and liabilities within which the asset would be used.
 - (b) The highest and best use of a non-financial asset might provide maximum value to market participants on a stand-alone basis. If the highest and best use of the asset is to use it on a stand-alone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a stand-alone basis.

- 32 The fair value measurement of a non-financial asset assumes that the asset is sold consistently with the unit of account specified in other HKFRSs (which may be an individual asset). That is the case even when that fair value measurement assumes that the highest and best use of the asset is to use it in combination with other assets or with other assets and liabilities because a fair value measurement assumes that the market participant already holds the complementary assets and the associated liabilities.
- 33 Paragraph B3 describes the application of the valuation premise concept for non-financial assets.

Application to liabilities and an entity's own equity instruments

General principles

- 34 A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (eg equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:
- (a) A liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
 - (b) An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.
- 35 Even when there is no observable market to provide pricing information about the transfer of a liability or an entity's own equity instrument (eg because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (eg a corporate bond or a call option on an entity's shares).
- 36 In all cases, an entity shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs to meet the objective of a fair value measurement, which is to estimate the price at which an orderly transaction to transfer the liability or equity instrument would take place between market participants at the measurement date under current market conditions.

Liabilities and equity instruments held by other parties as assets

- 37 When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date.

- 38 In such cases, an entity shall measure the fair value of the liability or equity instrument as follows:
- (a) using the quoted price in an *active market* for the identical item held by another party as an asset, if that price is available.
 - (b) if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.
 - (c) if the observable prices in (a) and (b) are not available, using another valuation technique, such as:
 - (i) an *income approach* (eg a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see paragraphs B10 and B11).
 - (ii) a *market approach* (eg using quoted prices for similar liabilities or equity instruments held by other parties as assets; see paragraphs B5–B7).
- 39 An entity shall adjust the quoted price of a liability or an entity's own equity instrument held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument. An entity shall ensure that the price of the asset does not reflect the effect of a restriction preventing the sale of that asset. Some factors that may indicate that the quoted price of the asset should be adjusted include the following:
- (a) The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. For example, the liability or equity instrument may have a particular characteristic (eg the credit quality of the issuer) that is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.
 - (b) The unit of account for the asset is not the same as for the liability or equity instrument. For example, for liabilities, in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is not for the combined package, the objective is to measure the fair value of the issuer's liability, not the fair value of the combined package. Thus, in such cases, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement.

Liabilities and equity instruments not held by other parties as assets

- 40 **When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is not held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity.**

- 41 For example, when applying a present value technique an entity might take into account either of the following:
- (a) the future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation (see paragraphs B31–B33).
 - (b) the amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing the identical item (eg having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms.

Non-performance risk

- 42 **The fair value of a liability reflects the effect of *non-performance risk*. Non-performance risk includes, but may not be limited to, an entity's own credit risk (as defined in HKFRS 7 *Financial Instruments: Disclosures*). Non-performance risk is assumed to be the same before and after the transfer of the liability.**
- 43 When measuring the fair value of a liability, an entity shall take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability, for example:
- (a) whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).
 - (b) the terms of credit enhancements related to the liability, if any.
- 44 The fair value of a liability reflects the effect of non-performance risk on the basis of its unit of account. The issuer of a liability issued with an inseparable third-party credit enhancement that is accounted for separately from the liability shall not include the effect of the credit enhancement (eg a third-party guarantee of debt) in the fair value measurement of the liability. If the credit enhancement is accounted for separately from the liability, the issuer would take into account its own credit standing and not that of the third party guarantor when measuring the fair value of the liability.

Restriction preventing the transfer of a liability or an entity's own equity instrument

- 45 When measuring the fair value of a liability or an entity's own equity instrument, an entity shall not include a separate input or an adjustment to other *inputs* relating to the existence of a restriction that prevents the transfer of the item. The effect of a restriction that prevents the transfer of a liability or an entity's own equity instrument is either implicitly or explicitly included in the other inputs to the fair value measurement.
- 46 For example, at the transaction date, both the creditor and the obligor accepted the transaction price for the liability with full knowledge that the obligation includes a restriction that prevents its transfer. As a result of the restriction being included in the transaction price, a separate input or an adjustment to an existing input is not required at the transaction date to reflect the effect of the restriction on transfer. Similarly, a separate input or an adjustment to an existing input is not required at subsequent measurement dates to reflect the effect of the restriction on transfer.

Financial liability with a demand feature

- 47 The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk

- 48 An entity that holds a group of financial assets and financial liabilities is exposed to market risks (as defined in HKFRS 7) and to the credit risk (as defined in HKFRS 7) of each of the counterparties. If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to this HKFRS for measuring fair value. That exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie an asset) for a particular risk exposure or to transfer a net short position (ie a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. Accordingly, an entity shall measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date.
- 49 An entity is permitted to use the exception in paragraph 48 only if the entity does all the following:
- (a) manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk (or –risks) or to the credit risk of a particular counterparty in accordance with the entity's documented risk management or investment strategy;
 - (b) provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel, as defined in HKAS 24 *Related Party Disclosures*; and
 - (c) is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.
- 50 The exception in paragraph 48 does not pertain to financial statement presentation. In some cases the basis for the presentation of financial instruments in the statement of financial position differs from the basis for the measurement of financial instruments, for example, if an HKFRS does not require or permit financial instruments to be presented on a net basis. In such cases an entity may need to allocate the portfolio-level adjustments (see paragraphs 53–56) to the individual assets or liabilities that make up the group of financial assets and financial liabilities managed on the basis of the entity's net risk exposure. An entity shall perform such allocations on a reasonable and consistent basis using a methodology appropriate in the circumstances.

- 51 An entity shall make an accounting policy decision in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to use the exception in paragraph 48. An entity that uses the exception shall apply that accounting policy, including its policy for allocating bid-ask adjustments (see paragraphs 53–55) and credit adjustments (see paragraph 56), if applicable, consistently from period to period for a particular portfolio.
- 52 The exception in paragraph 48 applies only to financial assets, financial liabilities and other contracts within the scope of HKFRS 9 *Financial Instruments* (or HKAS 39 *Financial Instruments: Recognition and Measurement*, if HKFRS 9 has not yet been adopted) ~~or HKFRS 9 *Financial Instruments*~~. The references to financial assets and financial liabilities in paragraphs 48–51 and 53–56 should be read as applying to all contracts within the scope of, and accounted for in accordance with, HKFRS 9 (or HKAS 39, if HKFRS 9 has not yet been adopted) ~~or HKFRS 9~~, regardless of whether they meet the definitions of financial assets or financial liabilities in HKAS 32 *Financial Instruments: Presentation*.

Exposure to market risks

- 53 When using the exception in paragraph 48 to measure the fair value of a group of financial assets and financial liabilities managed on the basis of the entity's net exposure to a particular market risk (or risks), the entity shall apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the entity's net exposure to those market risks (see paragraphs 70 and 71).
- 54 When using the exception in paragraph 48, an entity shall ensure that the market risk (or risks) to which the entity is exposed within that group of financial assets and financial liabilities is substantially the same. For example, an entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the entity's exposure to interest rate risk or commodity price risk. When using the exception in paragraph 48, any basis risk resulting from the market risk parameters not being identical shall be taken into account in the fair value measurement of the financial assets and financial liabilities within the group.
- 55 Similarly, the duration of the entity's exposure to a particular market risk (or risks) arising from the financial assets and financial liabilities shall be substantially the same. For example, an entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a five-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (ie years 2–5) on a gross basis.

Exposure to the credit risk of a particular counterparty

- 56 When using the exception in paragraph 48 to measure the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty, the entity shall include the effect of the entity's net exposure to the credit risk of that counterparty or the counterparty's net exposure to the credit risk of the entity in the fair value measurement when market participants would take into account any existing arrangements that mitigate credit risk exposure in the event of default (eg a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party). The fair value measurement shall reflect market participants' expectations about the likelihood that such an arrangement would be legally enforceable in the event of default.

Fair value at initial recognition

- 57 When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an *entry price*). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an *exit price*). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.
- 58 In many cases the transaction price will equal the fair value (eg that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).
- 59 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. Paragraph B4 describes situations in which the transaction price might not represent the fair value of an asset or a liability at initial recognition.
- 60 If another HKFRS requires or permits an entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the entity shall recognise the resulting gain or loss in profit or loss unless that HKFRS specifies otherwise.

Valuation techniques

- 61 **An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.**
- 62 The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Three widely used valuation techniques are the market approach, the *cost approach* and the income approach. The main aspects of those approaches are summarised in paragraphs B5–B11. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.
- 63 In some cases a single valuation technique will be appropriate (eg when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (eg that might be the case when valuing a cash-generating unit). If multiple valuation techniques are used to measure fair value, the results (ie respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.
- 64 If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. Calibration ensures that the valuation technique reflects current market conditions, and it helps an entity to determine whether an adjustment to the valuation technique is necessary (eg there might be a characteristic of the asset or liability that is not captured by the valuation technique). After initial recognition, when measuring fair value using a valuation technique or techniques that use unobservable inputs, an entity shall ensure that those valuation techniques reflect observable market data (eg the price for a similar asset or liability) at the measurement date.
- 65 Valuation techniques used to measure fair value shall be applied consistently. However, a change in a valuation technique or its application (eg a change in its

weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, any of the following events take place:

- (a) new markets develop;
- (b) new information becomes available;
- (c) information previously used is no longer available;
- (d) valuation techniques improve; or
- (e) market conditions change.

- 66 Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with HKAS 8. However, the disclosures in HKAS 8 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to valuation techniques

General principles

- 67 **Valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.**
- 68 Examples of markets in which inputs might be observable for some assets and liabilities (eg financial instruments) include exchange markets, dealer markets, brokered markets and principal-to-principal markets (see paragraph B34).
- 69 An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see paragraphs 11 and 12). In some cases those characteristics result in the application of an adjustment, such as a premium or discount (eg a control premium or non-controlling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the HKFRS that requires or permits the fair value measurement (see paragraphs 13 and 14). Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 80) rather than as a characteristic of the asset or liability (eg a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. In all cases, if there is a quoted price in an active market (ie a *Level 1 input*) for an asset or a liability, an entity shall use that price without adjustment when measuring fair value, except as specified in paragraph 79.

Inputs based on bid and ask prices

- 70 If an asset or a liability measured at fair value has a bid price and an ask price (eg an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorised within the fair value hierarchy (ie Level 1, 2 or 3; see paragraphs 72–90). The use of bid prices for asset positions and ask prices for liability positions is permitted, but is not required.
- 71 This HKFRS does not preclude the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient for fair value measurements within a bid-ask spread.

Fair value hierarchy

- 72 To increase consistency and comparability in fair value measurements and related disclosures, this HKFRS establishes a fair value hierarchy that categorises into three levels (see paragraphs 76–90) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (*Level 3 inputs*).
- 73 In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset or liability. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorised.
- 74 The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques (see paragraph 61). However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorised.
- 75 If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy. For example, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a *Level 2 input* and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

Level 1 inputs

- 76 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- 77 A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 79.
- 78 A Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (eg on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:
- (a) the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability; and
 - (b) whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.
- 79 An entity shall not make an adjustment to a Level 1 input except in the following circumstances:
- (a) when an entity holds a large number of similar (but not identical) assets or liabilities (eg debt securities) that are measured at fair value and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities individually (ie given the large number of similar assets or liabilities held by the entity, it would be difficult to obtain pricing information for each individual asset or liability at the measurement date). In that case, as a practical expedient, an entity may measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (eg matrix pricing). However, the use of an alternative pricing method results in a fair value measurement categorised within a lower level of the fair value hierarchy.
 - (b) when a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events (such as transactions in a principal-to-principal market, trades in a brokered market or announcements) take place after the close of a market but before the measurement date. An entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a fair value measurement categorised within a lower level of the fair value hierarchy.
 - (c) when measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset (see paragraph 39). If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorised within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorised within a lower level of the fair value hierarchy.

- 80 If an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability shall be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity. That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Level 2 inputs

- 81 Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- 82 If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:
- (a) quoted prices for similar assets or liabilities in active markets.
 - (b) quoted prices for identical or similar assets or liabilities in markets that are not active.
 - (c) inputs other than quoted prices that are observable for the asset or liability, for example:
 - (i) interest rates and yield curves observable at commonly quoted intervals;
 - (ii) implied volatilities; and
 - (iii) credit spreads.
 - (d) *market-corroborated inputs*.
- 83 Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:
- (a) the condition or location of the asset;
 - (b) the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in paragraph 39); and
 - (c) the volume or level of activity in the markets within which the inputs are observed.
- 84 An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.
- 85 Paragraph B35 describes the use of Level 2 inputs for particular assets and liabilities.

Level 3 inputs

- 86 Level 3 inputs are unobservable inputs for the asset or liability.
- 87 Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.
- 88 Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty (eg when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value, as described in paragraphs B37–B47).
- 89 An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.
- 90 Paragraph B36 describes the use of Level 3 inputs for particular assets and liabilities.

Disclosure

- 91 **An entity shall disclose information that helps users of its financial statements assess both of the following:**
- (a) for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.**
 - (b) for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.**

- 92 To meet the objectives in paragraph 91, an entity shall consider all the following:
- (a) the level of detail necessary to satisfy the disclosure requirements;
 - (b) how much emphasis to place on each of the various requirements;
 - (c) how much aggregation or disaggregation to undertake; and
 - (d) whether users of financial statements need additional information to evaluate the quantitative information disclosed.

If the disclosures provided in accordance with this HKFRS and other HKFRSs are insufficient to meet the objectives in paragraph 91, an entity shall disclose additional information necessary to meet those objectives.

- 93 To meet the objectives in paragraph 91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this HKFRS) in the statement of financial position after initial recognition:
- (a) for recurring and non-recurring fair value measurements, the fair value measurement at the end of the reporting period, and for non-recurring fair value measurements, the reasons for the measurement. Recurring fair value measurements of assets or liabilities are those that other HKFRSs require or permit in the statement of financial position at the end of each reporting period. Non-recurring fair value measurements of assets or liabilities are those that other HKFRSs require or permit in the statement of financial position in particular circumstances (eg when an entity measures an asset held for sale at fair value less costs to sell in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* because the asset's fair value less costs to sell is lower than its carrying amount).
 - (b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).
 - (c) for assets and liabilities held at the end of the reporting period that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred (see paragraph 95). Transfers into each level shall be disclosed and discussed separately from transfers out of each level.
 - (d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in valuation technique (eg changing from a market approach to an income approach or the use of an additional valuation technique), the entity shall disclose that change and the reason(s) for making it. For fair value measurements categorised within Level 3 of the fair value hierarchy, an entity shall provide quantitative information about the significant unobservable inputs used in the fair value measurement. An entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the entity when measuring fair value (eg when an entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure an entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity.
 - (e) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

- (i) total gains or losses for the period recognised in profit or loss, and the line item(s) in profit or loss in which those gains or losses are recognised.
 - (ii) total gains or losses for the period recognised in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognised.
 - (iii) purchases, sales, issues and settlements (each of those types of changes disclosed separately).
 - (iv) the amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred (see paragraph 95). Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.
- (f) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period in (e)(i) included in profit or loss that is attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in profit or loss in which those unrealised gains or losses are recognised.
- (g) for recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).
- (h) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy:
- (i) for all such measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include, at a minimum, the unobservable inputs disclosed when complying with (d).
 - (ii) for financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated. For that purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity.
- (i) for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.

94 An entity shall determine appropriate classes of assets and liabilities on the basis of the following:

- (a) the nature, characteristics and risks of the asset or liability; and

- (b) the level of the fair value hierarchy within which the fair value measurement is categorised.

The number of classes may need to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. Determining appropriate classes of assets and liabilities for which disclosures about fair value measurements should be provided requires judgement. A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position. However, an entity shall provide information sufficient to permit reconciliation to the line items presented in the statement of financial position. If another HKFRS specifies the class for an asset or a liability, an entity may use that class in providing the disclosures required in this HKFRS if that class meets the requirements in this paragraph.

- 95 An entity shall disclose and consistently follow its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred in accordance with paragraph 93(c) and (e)(iv). The policy about the timing of recognising transfers shall be the same for transfers into the levels as for transfers out of the levels. Examples of policies for determining the timing of transfers include the following:
 - (a) the date of the event or change in circumstances that caused the transfer.
 - (b) the beginning of the reporting period.
 - (c) the end of the reporting period.
- 96 If an entity makes an accounting policy decision to use the exception in paragraph 48, it shall disclose that fact.
- 97 For each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, an entity shall disclose the information required by paragraph 93(b), (d) and (i). However, an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy required by paragraph 93(d). For such assets and liabilities, an entity does not need to provide the other disclosures required by this HKFRS.
- 98 For a liability measured at fair value and issued with an inseparable third-party credit enhancement, an issuer shall disclose the existence of that credit enhancement and whether it is reflected in the fair value measurement of the liability.
- 99 An entity shall present the quantitative disclosures required by this HKFRS in a tabular format unless another format is more appropriate.

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
cost approach	A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
entry price	The price paid to acquire an asset or received to assume a liability in an exchange transaction.
exit price	The price that would be received to sell an asset or paid to transfer a liability.
expected cash flow	The probability-weighted average (ie mean of the distribution) of possible future cash flows.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
highest and best use	The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (eg a business) within which the asset would be used.
income approach	Valuation techniques that convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.
inputs	The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following: (a) the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and (b) the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable.
Level 1 inputs	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
Level 2 inputs	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3 inputs	Unobservable inputs for the asset or liability.

market approach	A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.
market-corroborated inputs	Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
market participants	Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: (a) They are independent of each other, ie they are not related parties as defined in HKAS 24, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms. (b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary. (c) They are able to enter into a transaction for the asset or liability. (d) They are willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.
most advantageous market	The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.
non-performance risk	The risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.
observable inputs	Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.
orderly transaction	A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale).
principal market	The market with the greatest volume and level of activity for the asset or liability.
risk premium	Compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability. Also referred to as a 'risk adjustment'.

transaction costs	The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria: (a) They result directly from and are essential to that transaction. (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in HKFRS 5).
transport costs	The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.
unit of account	The level at which an asset or a liability is aggregated or disaggregated in a HKFRS for recognition purposes.
unobservable inputs	Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

Appendix B

Application guidance

This appendix is an integral part of the HKFRS. It describes the application of paragraphs 1–99 and has the same authority as the other parts of the HKFRS.

- B1 The judgements applied in different valuation situations may be different. This appendix describes the judgements that might apply when an entity measures fair value in different valuation situations.

The fair value measurement approach

- B2 The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:
- (a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).
 - (b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).
 - (c) the principal (or most advantageous) market for the asset or liability.
 - (d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

Valuation premise for non-financial assets (paragraphs 31–33)

- B3 When measuring the fair value of a non-financial asset used in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (eg a business), the effect of the valuation premise depends on the circumstances. For example:
- (a) the fair value of the asset might be the same whether the asset is used on a stand-alone basis or in combination with other assets or with other assets and liabilities. That might be the case if the asset is a business that market participants would continue to operate. In that case, the transaction would involve valuing the business in its entirety. The use of the assets as a group in an ongoing business would generate synergies that would be available to market participants (ie market participant synergies that, therefore, should affect the fair value of the asset on either a stand-alone basis or in combination with other assets or with other assets and liabilities).
 - (b) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the fair value measurement through adjustments to the value of the asset used on a stand-alone basis. That might be the case if the asset is a machine and the fair value measurement is determined using an observed price for a similar machine (not installed or otherwise configured for use), adjusted for transport and installation costs so that the fair value measurement reflects the current condition and location of the machine (installed and configured for use).
 - (c) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the fair value measurement through the market participant assumptions used to measure the fair value of the asset. For example, if the asset is work in progress inventory that is unique and market participants would convert the inventory into finished goods, the fair value of the inventory would assume that market participants have acquired or would acquire

any specialised machinery necessary to convert the inventory into finished goods.

- (d) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the valuation technique used to measure the fair value of the asset. That might be the case when using the multi-period excess earnings method to measure the fair value of an intangible asset because that valuation technique specifically takes into account the contribution of any complementary assets and the associated liabilities in the group in which such an intangible asset would be used.
- (e) in more limited situations, when an entity uses an asset within a group of assets, the entity might measure the asset at an amount that approximates its fair value when allocating the fair value of the asset group to the individual assets of the group. That might be the case if the valuation involves real property and the fair value of improved property (ie an asset group) is allocated to its component assets (such as land and improvements).

Fair value at initial recognition (paragraphs 57–60)

- B4 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:
- (a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
 - (b) The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.
 - (c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (eg in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another HKFRS, or the transaction price includes transaction costs.
 - (d) The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.

Valuation techniques (paragraphs 61–66)

Market approach

- B5 The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.
- B6 For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

- B7 Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities.

Cost approach

- B8 The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
- B9 From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.

Income approach

- B10 The income approach converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.
- B11 Those valuation techniques include, for example, the following:
- (a) present value techniques (see paragraphs B12–B30);
 - (b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (ie a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and
 - (c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

Present value techniques

- B12 Paragraphs B13–B30 describe the use of present value techniques to measure fair value. Those paragraphs focus on a discount rate adjustment technique and an *expected cash flow* (expected present value) technique. Those paragraphs neither prescribe the use of a single specific present value technique nor limit the use of present value techniques to measure fair value to the techniques discussed. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (eg whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

The components of a present value measurement

- B13 Present value (ie an application of the income approach) is a tool used to link future amounts (eg cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all the following elements from the perspective of market participants at the measurement date:

- (a) an estimate of future cash flows for the asset or liability being measured.
- (b) expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
- (c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (ie a risk-free interest rate).
- (d) the price for bearing the uncertainty inherent in the cash flows (ie a *risk premium*).
- (e) other factors that market participants would take into account in the circumstances.
- (f) for a liability, the non-performance risk relating to that liability, including the entity's (ie the obligor's) own credit risk.

General principles

B14 Present value techniques differ in how they capture the elements in paragraph B13. However, all the following general principles govern the application of any present value technique used to measure fair value:

- (a) Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability.
- (b) Cash flows and discount rates should take into account only the factors attributable to the asset or liability being measured.
- (c) To avoid double-counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects the uncertainty in expectations about future defaults is appropriate if using contractual cash flows of a loan (ie a discount rate adjustment technique). That same rate should not be used if using expected (ie probability-weighted) cash flows (ie an expected present value technique) because the expected cash flows already reflect assumptions about the uncertainty in future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used.
- (d) Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows, which include the effect of inflation, should be discounted at a rate that includes the effect of inflation. The nominal risk-free interest rate includes the effect of inflation. Real cash flows, which exclude the effect of inflation, should be discounted at a rate that excludes the effect of inflation. Similarly, after-tax cash flows should be discounted using an after-tax discount rate. Pre-tax cash flows should be discounted at a rate consistent with those cash flows.
- (e) Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Risk and uncertainty

B15 A fair value measurement using present value techniques is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases both the amount and timing of the cash flows are uncertain. Even contractually fixed amounts, such as the payments on a loan, are uncertain if there is risk of default.

B16 Market participants generally seek compensation (ie a risk premium) for bearing the uncertainty inherent in the cash flows of an asset or a liability. A fair value

measurement should include a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient reason to exclude a risk premium.

- B17 Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example:
- (a) The discount rate adjustment technique (see paragraphs B18–B22) uses a risk-adjusted discount rate and contractual, promised or most likely cash flows.
 - (b) Method 1 of the expected present value technique (see paragraph B25) uses risk-adjusted expected cash flows and a risk-free rate.
 - (c) Method 2 of the expected present value technique (see paragraph B26) uses expected cash flows that are not risk-adjusted and a discount rate adjusted to include the risk premium that market participants require. That rate is different from the rate used in the discount rate adjustment technique.

Discount rate adjustment technique

- B18 The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (eg contractual or promised cash flows for a bond are conditional on the event of no default by the debtor). The discount rate used in the discount rate adjustment technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the contractual, promised or most likely cash flows are discounted at an observed or estimated market rate for such conditional cash flows (ie a market rate of return).
- B19 The discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities. Comparability is established by considering the nature of the cash flows (eg whether the cash flows are contractual or non-contractual and are likely to respond similarly to changes in economic conditions), as well as other factors (eg credit standing, collateral, duration, restrictive covenants and liquidity). Alternatively, if a single comparable asset or liability does not fairly reflect the risk inherent in the cash flows of the asset or liability being measured, it may be possible to derive a discount rate using data for several comparable assets or liabilities in conjunction with the risk-free yield curve (ie using a 'build-up' approach).
- B20 To illustrate a build-up approach, assume that Asset A is a contractual right to receive CU800* in one year (ie there is no timing uncertainty). There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:
- (a) Asset B is a contractual right to receive CU1,200 in one year and has a market price of CU1,083. Thus, the implied annual rate of return (ie a one-year market rate of return) is 10.8 per cent $[(CU1,200/CU1,083) - 1]$.
 - (b) Asset C is a contractual right to receive CU700 in two years and has a market price of CU566. Thus, the implied annual rate of return (ie a two-year market rate of return) is 11.2 per cent $[(CU700/CU566)^{0.5} - 1]$.
 - (c) All three assets are comparable with respect to risk (ie dispersion of possible pay-offs and credit).
- B21 On the basis of the timing of the contractual payments to be received for Asset A relative to the timing for Asset B and Asset C (ie one year for Asset B versus two years for Asset C), Asset B is deemed more comparable to Asset A. Using the contractual

* In this HKFRS monetary amounts are denominated in 'currency units (CU)'.

payment to be received for Asset A (CU800) and the one-year market rate derived from Asset B (10.8 per cent), the fair value of Asset A is CU722 ($CU800/1.108$). Alternatively, in the absence of available market information for Asset B, the one-year market rate could be derived from Asset C using the build-up approach. In that case the two-year market rate indicated by Asset C (11.2 per cent) would be adjusted to a one-year market rate using the term structure of the risk-free yield curve. Additional information and analysis might be required to determine whether the risk premiums for one-year and two-year assets are the same. If it is determined that the risk premiums for one-year and two-year assets are not the same, the two-year market rate of return would be further adjusted for that effect.

- B22 When the discount rate adjustment technique is applied to fixed receipts or payments, the adjustment for risk inherent in the cash flows of the asset or liability being measured is included in the discount rate. In some applications of the discount rate adjustment technique to cash flows that are not fixed receipts or payments, an adjustment to the cash flows may be necessary to achieve comparability with the observed asset or liability from which the discount rate is derived.

Expected present value technique

- B23 The expected present value technique uses as a starting point a set of cash flows that represents the probability-weighted average of all possible future cash flows (ie the expected cash flows). The resulting estimate is identical to expected value, which, in statistical terms, is the weighted average of a discrete random variable's possible values with the respective probabilities as the weights. Because all possible cash flows are probability-weighted, the resulting expected cash flow is not conditional upon the occurrence of any specified event (unlike the cash flows used in the discount rate adjustment technique).
- B24 In making an investment decision, risk-averse market participants would take into account the risk that the actual cash flows may differ from the expected cash flows. Portfolio theory distinguishes between two types of risk:
- (a) unsystematic (diversifiable) risk, which is the risk specific to a particular asset or liability.
 - (b) systematic (non-diversifiable) risk, which is the common risk shared by an asset or a liability with the other items in a diversified portfolio.
- Portfolio theory holds that in a market in equilibrium, market participants will be compensated only for bearing the systematic risk inherent in the cash flows. (In markets that are inefficient or out of equilibrium, other forms of return or compensation might be available.)
- B25 Method 1 of the expected present value technique adjusts the expected cash flows of an asset for systematic (ie market) risk by subtracting a cash risk premium (ie risk-adjusted expected cash flows). Those risk-adjusted expected cash flows represent a certainty-equivalent cash flow, which is discounted at a risk-free interest rate. A certainty-equivalent cash flow refers to an expected cash flow (as defined), adjusted for risk so that a market participant is indifferent to trading a certain cash flow for an expected cash flow. For example, if a market participant was willing to trade an expected cash flow of CU1,200 for a certain cash flow of CU1,000, the CU1,000 is the certainty equivalent of the CU1,200 (ie the CU200 would represent the cash risk premium). In that case the market participant would be indifferent as to the asset held.
- B26 In contrast, Method 2 of the expected present value technique adjusts for systematic (ie market) risk by applying a risk premium to the risk-free interest rate. Accordingly, the expected cash flows are discounted at a rate that corresponds to an expected rate associated with probability-weighted cash flows (ie an expected rate of return). Models used for pricing risky assets, such as the capital asset pricing model, can be used to estimate the expected rate of return. Because the discount rate used in the discount rate adjustment technique is a rate of return relating to conditional cash flows, it is likely to be higher than the discount rate used in Method 2 of the expected present value technique, which is an expected rate of return relating to expected or probability-weighted cash flows.

- B27 To illustrate Methods 1 and 2, assume that an asset has expected cash flows of CU780 in one year determined on the basis of the possible cash flows and probabilities shown below. The applicable risk-free interest rate for cash flows with a one-year horizon is 5 per cent, and the systematic risk premium for an asset with the same risk profile is 3 per cent.

Possible cash flows	Probability	Probability-weighted cash flows
CU500	15%	CU75
CU800	60%	CU480
CU900	25%	CU225
Expected cash flows		CU780

- B28 In this simple illustration, the expected cash flows (CU780) represent the probability-weighted average of the three possible outcomes. In more realistic situations, there could be many possible outcomes. However, to apply the expected present value technique, it is not always necessary to take into account distributions of all possible cash flows using complex models and techniques. Rather, it might be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. For example, an entity might use realised cash flows for some relevant past period, adjusted for changes in circumstances occurring subsequently (eg changes in external factors, including economic or market conditions, industry trends and competition as well as changes in internal factors affecting the entity more specifically), taking into account the assumptions of market participants.
- B29 In theory, the present value (ie the fair value) of the asset's cash flows is the same whether determined using Method 1 or Method 2, as follows:
- Using Method 1, the expected cash flows are adjusted for systematic (ie market) risk. In the absence of market data directly indicating the amount of the risk adjustment, such adjustment could be derived from an asset pricing model using the concept of certainty equivalents. For example, the risk adjustment (ie the cash risk premium of CU22) could be determined using the systematic risk premium of 3 per cent ($CU780 - [CU780 \times (1.05/1.08)]$), which results in risk-adjusted expected cash flows of CU758 ($CU780 - CU22$). The CU758 is the certainty equivalent of CU780 and is discounted at the risk-free interest rate (5 per cent). The present value (ie the fair value) of the asset is CU722 ($CU758/1.05$).
 - Using Method 2, the expected cash flows are not adjusted for systematic (ie market) risk. Rather, the adjustment for that risk is included in the discount rate. Thus, the expected cash flows are discounted at an expected rate of return of 8 per cent (ie the 5 per cent risk-free interest rate plus the 3 per cent systematic risk premium). The present value (ie the fair value) of the asset is CU722 ($CU780/1.08$).

- B30 When using an expected present value technique to measure fair value, either Method 1 or Method 2 could be used. The selection of Method 1 or Method 2 will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available and the judgements applied.

Applying present value techniques to liabilities and an entity's own equity instruments not held by other parties as assets (paragraphs 40 and 41)

- B31 When using a present value technique to measure the fair value of a liability that is not held by another party as an asset (eg a decommissioning liability), an entity shall, among other things, estimate the future cash outflows that market participants would expect to incur in fulfilling the obligation. Those future cash outflows shall include market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation. Such compensation includes the return that a market participant would require for the following:
- (a) undertaking the activity (ie the value of fulfilling the obligation; eg by using resources that could be used for other activities); and
 - (b) assuming the risk associated with the obligation (ie a *risk premium* that reflects the risk that the actual cash outflows might differ from the expected cash outflows; see paragraph B33).
- B32 For example, a non-financial liability does not contain a contractual rate of return and there is no observable market yield for that liability. In some cases the components of the return that market participants would require will be indistinguishable from one another (eg when using the price a third party contractor would charge on a fixed fee basis). In other cases an entity needs to estimate those components separately (eg when using the price a third party contractor would charge on a cost plus basis because the contractor in that case would not bear the risk of future changes in costs).
- B33 An entity can include a risk premium in the fair value measurement of a liability or an entity's own equity instrument that is not held by another party as an asset in one of the following ways:
- (a) by adjusting the cash flows (ie as an increase in the amount of cash outflows); or
 - (b) by adjusting the rate used to discount the future cash flows to their present values (ie as a reduction in the discount rate).

An entity shall ensure that it does not double-count or omit adjustments for risk. For example, if the estimated cash flows are increased to take into account the compensation for assuming the risk associated with the obligation, the discount rate should not be adjusted to reflect that risk.

Inputs to valuation techniques (paragraphs 67–71)

- B34 Examples of markets in which inputs might be observable for some assets and liabilities (eg financial instruments) include the following:
- (a) *Exchange markets.* In an exchange market, closing prices are both readily available and generally representative of fair value. An example of such a market is the London Stock Exchange.
 - (b) *Dealer markets.* In a dealer market, dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically bid and ask prices (representing the price at which the dealer is willing to buy and the price at which the dealer is willing to sell, respectively) are more readily available than closing prices. Over-the-counter markets (for which prices are publicly reported) are dealer markets. Dealer markets also exist for some other assets and liabilities, including some financial instruments, commodities and physical assets (eg used equipment).
 - (c) *Brokered markets.* In a brokered market, brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. In other words, brokers do not use their own capital to hold an inventory of the items for which they make a market. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party's price requirements. Prices of completed transactions are sometimes available. Brokered markets include electronic communication networks, in which buy and sell orders are matched, and commercial and residential real estate markets.
 - (d) *Principal-to-principal markets.* In a principal-to-principal market, transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be made available publicly.

Fair value hierarchy (paragraphs 72–90)

Level 2 inputs (paragraphs 81–85)

- B35 Examples of Level 2 inputs for particular assets and liabilities include the following:
- (a) *Receive-fixed, pay-variable interest rate swap based on the London Interbank Offered Rate (LIBOR) swap rate.* A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
 - (b) *Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency.* A Level 2 input would be the swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.

- (c) *Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate.* A Level 2 input would be the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.
- (d) *Three-year option on exchange-traded shares.* A Level 2 input would be the implied volatility for the shares derived through extrapolation to year 3 if both of the following conditions exist:
 - (i) Prices for one-year and two-year options on the shares are observable.
 - (ii) The extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option.

In that case the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established.

- (e) *Licensing arrangement.* For a licensing arrangement that is acquired in a business combination and was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would be the royalty rate in the contract with the unrelated party at inception of the arrangement.
- (f) *Finished goods inventory at a retail outlet.* For finished goods inventory that is acquired in a business combination, a Level 2 input would be either a price to customers in a retail market or a price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (ie similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments should be used for the fair value measurement.
- (g) *Building held and used.* A Level 2 input would be the price per square metre for the building (a valuation multiple) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (ie similar) buildings in similar locations.
- (h) *Cash-generating unit.* A Level 2 input would be a valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (ie similar) businesses, taking into account operational, market, financial and non-financial factors.

Level 3 inputs (paragraphs 86–90)

B36 Examples of Level 3 inputs for particular assets and liabilities include the following:

- (a) *Long-dated currency swap.* A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.
- (b) *Three-year option on exchange-traded shares.* A Level 3 input would be historical volatility, ie the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market

participants' expectations about future volatility, even if it is the only information available to price an option.

- (c) *Interest rate swap.* A Level 3 input would be an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.
- (d) *Decommissioning liability assumed in a business combination.* A Level 3 input would be a current estimate using the entity's own data about the future cash outflows to be paid to fulfil the obligation (including market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation to dismantle the asset) if there is no reasonably available information that indicates that market participants would use different assumptions. That Level 3 input would be used in a present value technique together with other inputs, eg a current risk-free interest rate or a credit-adjusted risk-free rate if the effect of the entity's credit standing on the fair value of the liability is reflected in the discount rate rather than in the estimate of future cash outflows.
- (e) *Cash-generating unit.* A Level 3 input would be a financial forecast (eg of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

Measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased

- B37 The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity for the asset or liability, an entity shall evaluate the significance and relevance of factors such as the following:
- (a) There are few recent transactions.
 - (b) Price quotations are not developed using current information.
 - (c) Price quotations vary substantially either over time or among market-makers (eg some brokered markets).
 - (d) Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

- (e) There is a significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows, taking into account all available market data about credit and other non-performance risk for the asset or liability.
 - (f) There is a wide bid-ask spread or significant increase in the bid-ask spread.
 - (g) There is a significant decline in the activity of, or there is an absence of, a market for new issues (ie a primary market) for the asset or liability or similar assets or liabilities.
 - (h) Little information is publicly available (eg for transactions that take place in a principal-to-principal market).
- B38 If an entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. However, if an entity determines that a transaction or quoted price does not represent fair value (eg there may be transactions that are not orderly), an adjustment to the transactions or quoted prices will be necessary if the entity uses those prices as a basis for measuring fair value and that adjustment may be significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (eg when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale).
- B39 This HKFRS does not prescribe a methodology for making significant adjustments to transactions or quoted prices. See paragraphs 61–66 and B5–B11 for a discussion of the use of valuation techniques when measuring fair value. Regardless of the valuation technique used, an entity shall include appropriate risk adjustments, including a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows of an asset or a liability (see paragraph B17). Otherwise, the measurement does not faithfully represent fair value. In some cases determining the appropriate risk adjustment might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. The risk adjustment shall be reflective of an orderly transaction between market participants at the measurement date under current market conditions.
- B40 If there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (eg the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, an entity shall consider the reasonableness of the range of fair value measurements. The objective is to determine the point within the range that is most representative of fair value under current market conditions. A wide range of fair value measurements may be an indication that further analysis is needed.
- B41 Even when there has been a significant decrease in the volume or level of activity for the asset or liability, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (ie not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions.
- B42 Estimating the price at which market participants would be willing to enter into a transaction at the measurement date under current market conditions if there has been a significant decrease in the volume or level of activity for the asset or liability depends on the facts and circumstances at the measurement date and requires judgement. An entity's intention to hold the asset or to settle or otherwise fulfil the

liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.

Identifying transactions that are not orderly

B43 The determination of whether a transaction is orderly (or is not orderly) is more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). In such circumstances it is not appropriate to conclude that all transactions in that market are not orderly (ie forced liquidations or distress sales). Circumstances that may indicate that a transaction is not orderly include the following:

- (a) There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
- (b) There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- (c) The seller is in or near bankruptcy or receivership (ie the seller is distressed).
- (d) The seller was required to sell to meet regulatory or legal requirements (ie the seller was forced).
- (e) The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability.

An entity shall evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.

B44 An entity shall consider all the following when measuring fair value or estimating market risk premiums:

- (a) If the evidence indicates that a transaction is not orderly, an entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price.
- (b) If the evidence indicates that a transaction is orderly, an entity shall take into account that transaction price. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances, such as the following:
 - (i) the volume of the transaction.
 - (ii) the comparability of the transaction to the asset or liability being measured.
 - (iii) the proximity of the transaction to the measurement date.

- (c) If an entity does not have sufficient information to conclude whether a transaction is orderly, it shall take into account the transaction price. However, that transaction price may not represent fair value (ie the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity shall place less weight on those transactions when compared with other transactions that are known to be orderly.

An entity need not undertake exhaustive efforts to determine whether a transaction is orderly, but it shall not ignore information that is reasonably available. When an entity is a party to a transaction, it is presumed to have sufficient information to conclude whether the transaction is orderly.

Using quoted prices provided by third parties

- B45 This HKFRS does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, if an entity has determined that the quoted prices provided by those parties are developed in accordance with this HKFRS.
- B46 If there has been a significant decrease in the volume or level of activity for the asset or liability, an entity shall evaluate whether the quoted prices provided by third parties are developed using current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risk). In weighting a quoted price as an input to a fair value measurement, an entity places less weight (when compared with other indications of fair value that reflect the results of transactions) on quotes that do not reflect the result of transactions.
- B47 Furthermore, the nature of a quote (eg whether the quote is an indicative price or a binding offer) shall be taken into account when weighting the available evidence, with more weight given to quotes provided by third parties that represent binding offers.

Appendix C

Effective date and transition

This appendix is an integral part of the HKFRS and has the same authority as the other parts of the HKFRS.

- C1 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies this HKFRS for an earlier period, it shall disclose that fact.
- C2 This HKFRS shall be applied prospectively as of the beginning of the annual period in which it is initially applied.
- C3 The disclosure requirements of this HKFRS need not be applied in comparative information provided for periods before initial application of this HKFRS.
- C4 *Annual Improvements Cycle 2011–2013* issued in January 2014 amended paragraph 52. An entity shall apply that amendment for annual periods beginning on or after 1 July 2014. An entity shall apply that amendment prospectively from the beginning of the annual period in which HKFRS 13 was initially applied. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.
- C5 HKFRS 9, as issued in September 2014, amended paragraph 52. An entity shall apply that amendment when it applies HKFRS 9.

Appendix D

Amendments to other HKFRSs

This appendix sets out amendments to other HKFRSs that are a consequence of issuing HKFRS 13. An entity shall apply the amendments for annual periods beginning on or after 1 January 2013. If an entity applies HKFRS 13 for an earlier period, it shall apply the amendments for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

The amendments contained in this appendix when this HKFRS was issued have been incorporated into the relevant HKFRSs.

Appendix E

Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared in June 2011 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKFRS 13.

The International Financial Reporting Standard comparable with HKFRS 13 is IFRS 13 *Financial Value Measurement*.

There are no major textual differences between HKFRS 13 and IFRS 13.

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 13*

Fair Value Measurement



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Certified Public Accountants
香港會計師公會

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Basis for Conclusions

HKFRS 13 *Fair Value Measurement*

HKFRS 13 is based on IFRS 13 *Fair Value Measurement*. In approving HKFRS 13, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 13. Accordingly, there are no significant differences between HKFRS 13 and IFRS 13. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 13 referred to below generally correspond with those in HKFRS 13.

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Basis for Conclusions on IFRS 13 *Fair Value Measurement*

This Basis for Conclusions accompanies, but is not part of, IFRS 13.

Introduction

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions in IFRS 13 *Fair Value Measurement*. It includes the reasons for accepting particular views and rejecting others. Individual IASB members gave greater weight to some factors than to others.
- BC2 IFRS 13 is the result of the IASB's discussions about measuring fair value and disclosing information about fair value measurements in accordance with International Financial Reporting Standards (IFRSs), including those held with the US national standard-setter, the Financial Accounting Standards Board (FASB), in their joint project on fair value measurement.
- BC3 As a result of those discussions, the FASB amended particular aspects of Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*[®] (which codified FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)). The FASB separately developed a Basis for Conclusions summarising its considerations in reaching the conclusions resulting in those amendments.

Overview

- BC4 Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. Because those IFRSs were developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements were dispersed and in many cases did not articulate a clear measurement or disclosure objective.
- BC5 As a result, some of those IFRSs contained limited guidance about how to measure fair value, whereas others contained extensive guidance and that guidance was not always consistent across those IFRSs that refer to fair value. Inconsistencies in the requirements for measuring fair value and for disclosing information about fair value measurements have contributed to diversity in practice and have reduced the comparability of information reported in financial statements.
- BC6 To remedy that situation, the IASB added a project to its agenda with the following objectives:
- (a) to establish a single set of requirements for all fair value measurements required or permitted by IFRSs to reduce complexity and improve consistency in their application, thereby enhancing the comparability of information reported in financial statements;
 - (b) to clarify the definition of fair value and related guidance to communicate the measurement objective more clearly;
 - (c) to enhance disclosures about fair value measurements that will help users of financial statements assess the valuation techniques and inputs used to develop fair value measurements; and
 - (d) to increase the convergence of IFRSs and US generally accepted accounting principles (GAAP).
- BC7 IFRS 13 is the result of that project. IFRS 13 is a single source of fair value measurement guidance that clarifies the definition of fair value, provides a clear framework for measuring fair value and enhances the disclosures about fair value measurements. It is also the result of the efforts of the IASB and the FASB to ensure

that fair value has the same meaning in IFRSs and in US GAAP and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style; see paragraphs BC237 and BC238 for the differences between IFRS 13 and Topic 820).

- BC8 IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures. It does not introduce new fair value measurements, nor does it eliminate practicability exceptions to fair value measurements (eg the exception in IAS 41 *Agriculture* when an entity is unable to measure reliably the fair value of a biological asset on initial recognition). In other words, IFRS 13 specifies *how* an entity should measure fair value and disclose information about fair value measurements. It does not specify *when* an entity should measure an asset, a liability or its own equity instrument at fair value.

Background

- BC9 The IASB and the FASB began developing their fair value measurement standards separately.
- BC10 The FASB began working on its fair value measurement project in June 2003. In September 2005, during the FASB's redeliberations on the project, the IASB added to its agenda a project to clarify the meaning of fair value and to provide guidance for its application in IFRSs.
- BC11 In September 2006 the FASB issued SFAS 157 (now in Topic 820). Topic 820 defines fair value, establishes a framework for measuring fair value and requires disclosures about fair value measurements.
- BC12 In November 2006 as a first step in developing a fair value measurement standard, the IASB published a discussion paper *Fair Value Measurements*. In that discussion paper, the IASB used SFAS 157 as a basis for its preliminary views because of the consistency of SFAS 157 with the existing fair value measurement guidance in IFRSs and the need for increased convergence of IFRSs and US GAAP. The IASB received 136 comment letters in response to that discussion paper. In November 2007 the IASB began its deliberations for the development of the exposure draft *Fair Value Measurement*.
- BC13 In May 2009 the IASB published that exposure draft, which proposed a definition of fair value, a framework for measuring fair value and disclosures about fair value measurements. Because the proposals in the exposure draft were developed using the requirements of SFAS 157, there were many similarities between them. However, some of those proposals were different from the requirements of SFAS 157 and many of them used wording that was similar, but not identical, to the wording in SFAS 157. The IASB received 160 comment letters in response to the proposals in the exposure draft. One of the most prevalent comments received was a request for the IASB and the FASB to work together to develop common fair value measurement and disclosure requirements in IFRSs and US GAAP.
- BC14 In response to that request, the IASB and the FASB agreed at their joint meeting in October 2009 to work together to develop common requirements. The boards concluded that having common requirements for fair value measurement and disclosure would improve the comparability of financial statements prepared in accordance with IFRSs and US GAAP. In addition, they concluded that having common requirements would reduce diversity in the application of fair value measurement requirements and would simplify financial reporting. To achieve those goals, the boards needed to ensure that fair value had the same meaning in IFRSs and US GAAP and that IFRSs and US GAAP had the same fair value measurement and disclosure requirements (except for minor differences in wording and style). Consequently, the FASB agreed to consider the comments received on the IASB's exposure draft and to propose amendments to US GAAP if necessary.

- BC15 The boards began their joint discussions in January 2010. They discussed nearly all the issues together so that each board would benefit from hearing the rationale for the other board's decisions on each issue. They initially focused on the following:
- (a) differences between the requirements in Topic 820 and the proposals in the IASB's exposure draft;
 - (b) comments received on the IASB's exposure draft (including comments received from participants at the IASB's round-table meetings held in November and December 2009); and
 - (c) feedback received on the implementation of Topic 820 (eg issues discussed by the FASB's Valuation Resource Group).
- BC16 In March 2010 the boards completed their initial discussions. As a result of those discussions, in June 2010 the FASB issued a proposed Accounting Standards Update (ASU) *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* and the IASB re-exposed a proposed disclosure of the unobservable inputs used in a fair value measurement (*Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*). The IASB concluded that it was necessary to re-expose that proposal because in their discussions the boards agreed to require a measurement uncertainty analysis disclosure that included the effect of any interrelationships between unobservable inputs (a requirement that was not proposed in the May 2009 exposure draft and was not already required by IFRSs). The IASB received 92 comment letters on the re-exposure document.
- BC17 In September 2010, after the end of the comment periods on the IASB's re-exposure document and the FASB's proposed ASU, the boards jointly considered the comments received on those exposure drafts. The boards completed their discussions in March 2011.
- BC18 Throughout the process, the IASB considered information from the IFRS Advisory Council, the Analysts' Representative Group and the IASB's Fair Value Expert Advisory Panel (see paragraph BC177) and from other interested parties.

Scope

- BC19 The boards separately discussed the scope of their respective fair value measurement standards because of the differences between IFRSs and US GAAP in the measurement bases specified in other standards for both initial recognition and subsequent measurement.
- BC20 IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except in the following circumstances:
- (a) The measurement and disclosure requirements of IFRS 13 do not apply to the following:
 - (i) share-based payment transactions within the scope of IFRS 2 *Share-based Payment*;
 - (ii) leasing transactions within the scope of IAS 17 *Leases*; and
 - (iii) measurements that have some similarities to fair value but are not fair value, such as net realisable value in accordance with IAS 2 *Inventories* and value in use in accordance with IAS 36 *Impairment of Assets*.
 - (b) The disclosures required by IFRS 13 are not required for the following:
 - (i) plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*;
 - (ii) retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*; and
 - (iii) assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.
- BC21 The exposure draft proposed introducing a new measurement basis for IFRS 2, a market-based value. The definition of *market-based value* would have been similar to the exit price definition of fair value except that it would specify that the measurement does not take into account market participant assumptions for vesting conditions and reload features. Respondents pointed out that some items measured at fair value in IFRS 2 were consistent with the proposed definition of fair value, not with the proposed definition of market-based value, and were concerned that there could be unintended consequences of moving forward with a market-based value measurement basis in IFRS 2. The IASB agreed with those comments and concluded that amending IFRS 2 to distinguish between measures that are fair value and those based on fair value would require new measurement guidance for measures based on fair value. The IASB concluded that such guidance might result in unintended changes in practice with regard to measuring share-based payment transactions and decided to exclude IFRS 2 from the scope of IFRS 13.
- BC22 The IASB concluded that applying the requirements in IFRS 13 might significantly change the classification of leases and the timing of recognising gains or losses for sale and leaseback transactions. Because there is a project under way to replace IAS 17, the IASB concluded that requiring entities to make potentially significant changes to their accounting systems for the IFRS on fair value measurement and then for the IFRS on lease accounting could be burdensome.

- BC23 The exposure draft proposed that the disclosures about fair value measurements would be required for the fair value of plan assets in IAS 19 and the fair value of retirement benefit plan investments in IAS 26. In its project to amend IAS 19 the IASB decided to require an entity to disaggregate the fair value of the plan assets into classes that distinguish the risk and liquidity characteristics of those assets, subdividing each class of debt and equity instruments into those that have a quoted market price in an active market and those that do not. As a result, the IASB decided that an entity does not need to provide the disclosures required by IFRS 13 for the fair value of plan assets or retirement benefit plan investments.
- BC24 The exposure draft was not explicit about whether the measurement and disclosure requirements in the exposure draft applied to measurements based on fair value, such as fair value less costs to sell in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* or IAS 41. In the boards' discussions, they concluded that the measurement and disclosure requirements should apply to all measurements for which fair value is the underlying measurement basis (except that the disclosure requirements would not apply to assets with a recoverable amount that is fair value less costs of disposal in IAS 36; see paragraphs BC218–BC221). Consequently, the boards decided to clarify that the measurement and disclosure requirements apply to both fair value measurements and measurements based on fair value. The boards also decided to clarify that the measurement and disclosure requirements do not apply to measurements that have similarities to fair value but are not fair value, such as net realisable value in accordance with IAS 2 or value in use in accordance with IAS 36.
- BC25 The boards decided to clarify that the measurement requirements apply when measuring the fair value of an asset or a liability that is not measured at fair value in the statement of financial position but for which the fair value is disclosed (eg for financial instruments subsequently measured at amortised cost in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*^{*} and for investment property subsequently measured using the cost model in accordance with IAS 40 *Investment Property*).
- BC26 The IASB decided that two of the proposals about scope in the exposure draft were not necessary:
- (a) The exposure draft proposed excluding financial liabilities with a demand feature in IAS 39^{*} from the scope of an IFRS on fair value measurement. In the light of the comments received, the IASB confirmed its decision when developing IAS 39 that the fair value of financial liabilities with a demand feature cannot be less than the present value of the demand amount (see paragraphs BC101–BC103) and decided to retain the term *fair value* for such financial liabilities.
 - (b) The exposure draft proposed replacing the term *fair value* with another term that reflects the measurement objective for reacquired rights in a business combination in IFRS 3 *Business Combinations*. In the redeliberations, the IASB concluded that because IFRS 3 already describes the measurement of reacquired rights as an exception to fair value, it was not necessary to change that wording.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Measurement

Definition of fair value

Clarifying the measurement objective

BC27 IFRS 13 defines fair value as:

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

BC28 IFRS 13 also provides a framework that is based on an objective to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (ie an exit price from the perspective of a market participant that holds the asset or owes the liability at the measurement date).

BC29 That definition of fair value retains the exchange notion contained in the previous definition of fair value in IFRSs:

The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

BC30 Like the previous definition of fair value, the revised definition assumes a hypothetical and orderly exchange transaction (ie it is not an actual sale or a forced transaction or distress sale). However, the previous definition of fair value:

- (a) did not specify whether an entity is buying or selling the asset;
- (b) was unclear about what is meant by settling a liability because it did not refer to the creditor, but to knowledgeable, willing parties; and
- (c) did not state explicitly whether the exchange or settlement takes place at the measurement date or at some other date.

BC31 The IASB concluded that the revised definition of fair value remedies those deficiencies. It also conveys more clearly that fair value is a market-based measurement, and not an entity-specific measurement, and that fair value reflects current market conditions (which reflect market participants', not the entity's, current expectations about future market conditions).

BC32 In determining how to define fair value in IFRSs, the IASB considered work done in its project to revise IFRS 3. In that project, the IASB considered whether differences between the definitions of fair value in US GAAP (an explicit exit price) and IFRSs (an exchange amount, which might be interpreted in some situations as an entry price) would result in different measurements of assets acquired and liabilities assumed in a business combination. That was a particularly important issue because in many business combinations the assets and liabilities are non-financial.

BC33 The IASB asked valuation experts to take part in a case study involving the valuation of the identifiable assets acquired and liabilities assumed in a sample business combination. The IASB learned that differences between an exit price and an exchange amount (which might be interpreted as an entry price in a business combination) were unlikely to arise, mainly because transaction costs are not a component of fair value in either definition. The IASB observed that although the definitions used different words, they articulated essentially the same concepts.

BC34 However, the valuation experts identified potential differences in particular areas. The valuation experts told the IASB that an exit price for an asset acquired or a liability assumed in a business combination might differ from an exchange amount if:

- (a) an entity's intended use for an acquired asset is different from its highest and best use by market participants (ie when the acquired asset provides defensive value); or

- (b) a liability is measured on the basis of settling it with the creditor rather than transferring it to a third party and the entity determines that there is a difference between those measurements. Paragraphs BC80–BC82 discuss perceived differences between the settlement and transfer notions.

BC35 With respect to highest and best use, the IASB understood that the ways of measuring assets on the basis of their defensive value (ie the value associated with improving the prospects of the entity's other assets by preventing the acquired asset from being used by competitors) in accordance with US GAAP at the time IFRS 3 was issued were still developing. As a consequence, the IASB thought it was too early to assess the significance of any differences that might result. With respect to liabilities, it was also not clear at that time whether entities would use different valuation techniques to measure the fair value of liabilities assumed in a business combination. In the development of IFRS 13, the IASB observed the discussions of the FASB's Valuation Resource Group to learn from the implementation of SFAS 157 and Topic 820 in US GAAP.

Fair value as a current exit price

- BC36 The definition of fair value in IFRS 13 is a current exit price. That definition in and of itself is not a controversial issue. Many respondents thought the proposal to define fair value as a current, market-based exit price was appropriate because that definition retains the notion of an exchange between unrelated, knowledgeable and willing parties in the previous definition of fair value in IFRSs, but provides a clearer measurement objective. Other respondents thought an entry price would be more appropriate in some situations (eg at initial recognition, such as in a business combination).
- BC37 However, the issue of *when* fair value should be used as a measurement basis in IFRSs is controversial. There is disagreement about the following:
- (a) which assets and liabilities should be measured at fair value (eg whether fair value should be restricted to assets and liabilities with quoted prices in active markets that the entity intends to sell or transfer in the near term);
 - (b) when those assets and liabilities should be measured at fair value (eg whether the measurement basis should change when markets have become less active); and
 - (c) where any changes in fair value should be recognised.
- BC38 Although IFRS 13 does not address when fair value should be used as a measurement basis for a particular asset or liability or revisit when fair value has been used in IFRSs, the IASB did consider whether each use of the term *fair value* in IFRSs was consistent with an exit price definition (see paragraphs BC41–BC45). Furthermore, IFRS 13 will inform the IASB in the future as it considers whether to require fair value as a measurement basis for a particular type of asset or liability.
- BC39 The IASB concluded that an exit price of an asset or a liability embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of a market participant that holds the asset or owes the liability at the measurement date. An entity generates cash inflows from an asset by using the asset or by selling it. Even if an entity intends to generate cash inflows from an asset by using it rather than by selling it, an exit price embodies expectations of cash flows arising from the use of the asset by selling it to a market participant that would use it in the same way. That is because a market participant buyer will pay only for the benefits it expects to generate from the use (or sale) of the asset. Thus, the IASB concluded that an exit price is always a relevant definition of fair value for assets, regardless of whether an entity intends to use an asset or sell it.
- BC40 Similarly, a liability gives rise to outflows of cash (or other economic resources) as an entity fulfils the obligation over time or when it transfers the obligation to another party.

Even if an entity intends to fulfil the obligation over time, an exit price embodies expectations of related cash outflows because a market participant transferee would ultimately be required to fulfil the obligation. Thus, the IASB concluded that an exit price is always a relevant definition of fair value for liabilities, regardless of whether an entity intends to fulfil the liability or transfer it to another party that will fulfil it.

- BC41 In developing the revised definition of fair value, the IASB completed a standard-by-standard review of fair value measurements required or permitted in IFRSs to assess whether the IASB or its predecessor intended each use of fair value to be a current exit price measurement basis. If it became evident that a current exit price was not the intention in a particular situation, the IASB would use another measurement basis to describe the objective. The other likely measurement basis candidate was a current entry price. For the standard-by-standard review, the IASB defined current entry price as follows:

The price that would be paid to buy an asset or received to incur a liability in an orderly transaction between market participants (including the amount imposed on an entity for incurring a liability) at the measurement date.

- BC42 That definition of current entry price, like fair value, assumes a hypothetical orderly transaction between market participants at the measurement date. It is not necessarily the same as the price an entity paid to acquire an asset or received to incur a liability, eg if that transaction was not at arm's length. In discussions with interested parties, the IASB found that most people who assert that an asset or a liability should be measured using an entry price measurement basis, rather than an exit price measurement basis, would actually prefer to use the entity's actual transaction price (or cost), not the market-based current entry price defined above. The IASB observed that in some cases there is not an actual transaction price (eg when a group of assets is acquired but the unit of account is an individual asset, or when a biological asset regenerates) and, as a result, an assumed, or hypothetical, price must be used.
- BC43 During the standard-by-standard review, the IASB asked various parties to provide information on whether, in practice, they interpreted fair value in a particular context in IFRSs as a current entry price or a current exit price. The IASB used that information in determining whether to define fair value as a current exit price, or to remove the term *fair value* and use the terms *current exit price* and *current entry price* depending on the measurement objective in each IFRS that used the term *fair value*.

- BC44 As a result of the standard-by-standard review, the IASB concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. Therefore, the IASB considered it unnecessary to make a distinction between a current entry price and a current exit price in IFRSs with a market-based measurement objective (ie fair value), and the IASB decided to retain the term fair value and define it as a current exit price.
- BC45 The IASB concluded that some fair value measurement requirements in IFRSs were inconsistent with a current exit price or the requirements for measuring fair value. For those fair value measurements, IFRS 13 excludes the measurement from its scope (see paragraphs BC19–BC26).

The asset or liability

- BC46 IFRS 13 states that a fair value measurement takes into account the characteristics of the asset or liability, eg the condition and location of the asset and restrictions, if any, on its sale or use. Restrictions on the sale or use of an asset affect its fair value if market participants would take the restrictions into account when pricing the asset at the measurement date. That is consistent with the fair value measurement guidance already in IFRSs. For example:
- (a) IAS 40 stated that an entity should identify any differences between the property being measured at fair value and similar properties for which observable market prices are available and make the appropriate adjustments; and
 - (b) IAS 41 referred to measuring the fair value of a biological asset or agricultural produce in its present location and condition.
- BC47 The IASB concluded that IFRS 13 should describe how to measure fair value, not what is being measured at fair value. Other IFRSs specify whether a fair value measurement considers an individual asset or liability or a group of assets or liabilities (ie the unit of account). For example:
- (a) IAS 36 states that an entity should measure the fair value less costs of disposal for a cash-generating unit when assessing its recoverable amount.
 - (b) In IAS 39* and IFRS 9 the unit of account is generally an individual financial instrument.

The transaction

- BC48 The exposure draft proposed that the transaction to sell an asset or transfer a liability takes place in the most advantageous market to which the entity has access. That was different from the approach in Topic 820, which refers to the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The IASB concluded that in most cases the principal market for an asset or a liability will be the most advantageous market and that an entity need not continuously monitor different markets in order to determine which market is most advantageous at the measurement date. That proposal contained a presumption that the market in which the entity normally enters into transactions for the asset or liability is the most advantageous market and that an entity may assume that the principal market for the asset or liability is the most advantageous market.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC49 Many respondents agreed with the most advantageous market notion because most entities enter into transactions that maximise the price received to sell an asset or minimise the price paid to transfer a liability. Furthermore, they thought that a most advantageous market notion works best for all assets and liabilities, regardless of the level of activity in a market or whether the market for an asset or a liability is observable.
- BC50 However, some respondents were concerned about the difficulty with identifying and selecting the most advantageous market when an asset or a liability is exchanged in multiple markets throughout the world. Other respondents found the guidance confusing because it was not clear whether the most advantageous market must be used or how the market in which the entity normally enters into transactions relates to the principal market or to the most advantageous market. In general, respondents preferred the approach in Topic 820.
- BC51 Although the boards think that in most cases the principal market and the most advantageous market would be the same, they concluded that the focus should be on the principal market for the asset or liability and decided to clarify the definition of the principal market.
- BC52 Some respondents to the exposure draft stated that the language in US GAAP was unclear about whether the principal market should be determined on the basis of the volume or level of activity *for the asset or liability* or on the volume or level of activity *of the reporting entity's transactions in a particular market*. Consequently, the boards decided to clarify that the principal market is the market for the asset or liability that has the greatest volume or level of activity *for the asset or liability*. Because the principal market is the most liquid market for the asset or liability, that market will provide the most representative input for a fair value measurement. As a result, the boards also decided to specify that a transaction to sell an asset or to transfer a liability takes place in the principal (or most advantageous) market, provided that the entity can access that market on the measurement date.
- BC53 In addition, the boards concluded that an entity normally enters into transactions in the principal market for the asset or liability (ie the most liquid market, assuming that the entity can access that market). As a result, the boards decided to specify that an entity can use the price in the market in which it normally enters into transactions, unless there is evidence that the principal market and that market are not the same. Consequently, an entity does not need to perform an exhaustive search for markets that might have more activity for the asset or liability than the market in which that entity normally enters into transactions. Thus, IFRS 13 addresses practical concerns about the costs of searching for the market with the greatest volume or level of activity for the asset or liability.
- BC54 The boards also concluded that the determination of the most advantageous market (which is used in the absence of a principal market) for an asset or a liability takes into account both transaction costs and transport costs. However, regardless of whether an entity measures fair value on the basis of the price in the principal market or in the most advantageous market, the fair value measurement takes into account transport costs, but not transaction costs (see paragraphs BC60–BC62 for a discussion on transport and transaction costs). That is consistent with the proposal in the exposure draft.

Market participants

- BC55 IFRS 13 states that a fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions that market participants would use when pricing the asset or liability.
- BC56 The previous definition of fair value in IFRSs referred to 'knowledgeable, willing parties in an arm's length transaction'. The IASB concluded that the previous definition expressed the same notion as the definition of fair value in IFRS 13, but that the

previous definition was less clear. Thus, IFRS 13 defines market participants as buyers and sellers in the principal (or most advantageous) market for the asset or liability who are independent of each other (ie they are not related parties), knowledgeable about the asset or liability, and able and willing to enter into a transaction for the asset or liability.

Independence

- BC57 IFRS 13 states that market participants are independent of each other (ie they are not related parties). That is consistent with the proposal in the exposure draft. Given that proposal, some respondents noted that in some jurisdictions entities often have common ownership (eg state-owned enterprises or entities with cross ownership) and questioned whether transactions observed in those jurisdictions would be permitted as an input into a fair value measurement. The boards decided to clarify that the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms. The boards concluded that this is consistent with IAS 24 *Related Party Disclosures*.

Knowledge

- BC58 The exposure draft stated that market participants were presumed to be as knowledgeable as the entity about the asset or liability. Some respondents questioned that conclusion because they thought the entity might have access to information that is not available to other market participants (information asymmetry).
- BC59 In the IASB's view, if a market participant is willing to enter into a transaction for an asset or a liability, it would undertake efforts, including usual and customary due diligence efforts, necessary to become knowledgeable about the asset or liability and would factor any related risk into the measurement.

The price

- BC60 IFRS 13 states that the price used to measure fair value should not be reduced (for an asset) or increased (for a liability) by the costs an entity would incur when selling the asset or transferring the liability (ie transaction costs).
- BC61 Some respondents stated that transaction costs are unavoidable when entering into a transaction for an asset or a liability. However, the IASB noted that the costs may differ depending on how a particular entity enters into a transaction. Therefore, the IASB concluded that transaction costs are not a characteristic of an asset or a liability, but a characteristic of the transaction. That decision is consistent with the requirements for measuring fair value already in IFRSs. An entity accounts for those costs in accordance with relevant IFRSs.
- BC62 Transaction costs are different from transport costs, which are the costs that would be incurred to transport the asset from its current location to its principal (or most advantageous) market. Unlike transaction costs, which arise from a transaction and do not change the characteristics of the asset or liability, transport costs arise from an event (transport) that does change a characteristic of an asset (its location). IFRS 13 states that if location is a characteristic of an asset, the price in the principal (or most advantageous) market should be adjusted for the costs that would be incurred to transport the asset from its current location to that market. That is consistent with the fair value measurement guidance already in IFRSs. For example, IAS 41 required an entity to deduct transport costs when measuring the fair value of a biological asset or agricultural produce.

Application to non-financial assets

Distinguishing between financial assets, non-financial assets and liabilities

BC63 The exposure draft stated that the concepts of highest and best use and valuation premise would not apply to financial assets or to liabilities.

The IASB reached that conclusion for the following reasons:

- (a) Financial assets do not have alternative uses because a financial asset has specific contractual terms and can have a different use only if the characteristics of the financial asset (ie the contractual terms) are changed. However, a change in characteristics causes that particular asset to become a different asset. The objective of a fair value measurement is to measure the asset that exists at the measurement date.
- (b) Even though an entity may be able to change the cash flows associated with a liability by relieving itself of the obligation in different ways, the different ways of doing so are not alternative uses. Moreover, although an entity might have entity-specific advantages or disadvantages that enable it to fulfil a liability more or less efficiently than other market participants, those entity-specific factors do not affect fair value.
- (c) Those concepts were originally developed within the valuation profession to value non-financial assets, such as land.

BC64 Before the amendments to Topic 820, US GAAP specified that the concepts of highest and best use and valuation premise applied when measuring the fair value of assets, but it did not distinguish between financial assets and non-financial assets.

BC65 The FASB agreed with the IASB that the concepts of highest and best use and valuation premise are relevant when measuring the fair value of non-financial assets, and are not relevant when measuring the fair value of financial assets or the fair value of liabilities. The boards also concluded that those concepts do not apply to an entity's own equity instruments because those arrangements, similar to financial instruments, typically have specific contractual terms. Paragraphs BC108–BC131 describe the boards' rationale in developing the requirements for measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks and counterparty credit risk.

- BC66 Some respondents to the FASB's proposed ASU were concerned that limiting the highest and best use concept to non-financial assets removed the concept of value maximisation by market participants, which they considered fundamental to a fair value measurement for financial assets and financial liabilities.
- BC67 The boards decided to clarify that although there are no excess returns available from holding financial assets and financial liabilities within a portfolio (because in an efficient market, the price reflects the benefits that market participants would derive from holding the asset or liability in a diversified portfolio), a fair value measurement assumes that market participants seek to maximise the fair value of a financial or non-financial asset or to minimise the fair value of a financial or non-financial liability by acting in their economic best interest in a transaction to sell the asset or to transfer the liability in the principal (or most advantageous) market for the asset or liability. Such a transaction might involve grouping assets and liabilities in a way in which market participants would enter into a transaction, if the unit of account in other IFRSs does not prohibit that grouping.

Highest and best use

- BC68 Highest and best use is a valuation concept used to value many non-financial assets (eg real estate). The highest and best use of a non-financial asset must be physically possible, legally permissible and financially feasible. In developing the proposals in the exposure draft, the IASB concluded that it was necessary to describe those three criteria, noting that US GAAP at the time did not.
- BC69 Some respondents asked for further guidance about whether a use that is legally permissible must be legal at the measurement date, or if, for example, future changes in legislation can be taken into account. The IASB concluded that a use of an asset does not need to be legal at the measurement date, but must not be legally prohibited in the jurisdiction (eg if the government of a particular country has prohibited building or development in a protected area, the highest and best use of the land in that area could not be to develop it for industrial use). The illustrative examples that accompany IFRS 13 show how an asset can be zoned for a particular use at the measurement date, but how a fair value measurement can assume a different zoning if market participants would do so (incorporating the cost to convert the asset and obtain that different zoning permission, including the risk that such permission would not be granted).
- BC70 IFRS 13 states that fair value takes into account the highest and best use of an asset from the perspective of market participants. That is the case even if an entity acquires an asset but, to protect its competitive position or for other reasons, the entity does not intend to use it actively or does not intend to use the asset in the same way as other market participants (eg if an intangible asset provides defensive value because the acquirer holds the asset to keep it from being used by competitors). When revising IFRS 3 in 2008, the IASB decided that an entity must recognise such an asset at fair value because the intention of IFRS 3 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them (see paragraph BC262 of IFRS 3). IFRS 13 sets out requirements for measuring the fair value of those assets.

- BC71 IFRS 13 does not require an entity to perform an exhaustive search for other potential uses of a non-financial asset if there is no evidence to suggest that the current use of an asset is not its highest and best use. The IASB concluded that an entity that seeks to maximise the value of its assets would use those assets at their highest and best use and that it would be necessary for an entity to consider alternative uses of those assets only if there was evidence that the current use of the assets is not their highest and best use (ie an alternative use would maximise their fair value). Furthermore, after discussions with valuation professionals, the IASB concluded that in many cases it would be unlikely for an asset's current use not to be its highest and best use after taking into account the costs to convert the asset to the alternative use.
- BC72 When the IASB was developing the proposals in the exposure draft, users of financial statements asked the IASB to consider how to account for assets when their highest and best use within a group of assets is different from their current use by the entity (ie when there is evidence that the current use of the assets is not their highest and best use, and an alternative use would maximise their fair value). For example, the fair value of a factory is linked to the value of the land on which it is situated. The fair value of the factory would be nil if the land has an alternative use that assumes the factory is demolished. The IASB concluded when developing the exposure draft that measuring the factory at nil would not provide useful information when an entity is using that factory in its operations. In particular, users would want to see depreciation on that factory so that they could assess the economic resources consumed in generating cash flows from its operation. Therefore, the exposure draft proposed requiring an entity to separate the fair value of the asset group into its current use and fair value components.
- BC73 Respondents found that proposal confusing and thought that calculating two values for a non-financial asset would be costly. As a result, the boards decided that when an entity uses a non-financial asset in a way that differs from its highest and best use (and that asset is measured at fair value), the entity must simply disclose that fact and why the asset is being used in a manner that differs from its highest and best use (see paragraphs BC213 and BC214).

Valuation premise

Terminology

- BC74 As an application of the highest and best use concept, the exposure draft identified two valuation premises that may be relevant when measuring the fair value of an asset:
- (a) The *in-use valuation premise*, which applies when the highest and best use of an asset is to use it with other assets or with other assets and liabilities as a group. The in-use valuation premise assumes that the exit price would be the price for a sale to a market participant that has, or can obtain, the other assets and liabilities needed to generate cash inflows by using the asset (complementary assets and the associated liabilities).
 - (b) The *in-exchange valuation premise*, which applies when the highest and best use of an asset is to use it on a stand-alone basis. It assumes that the sale would be to a market participant that uses the asset on a stand-alone basis.

- BC75 Many respondents found the terms *in use* and *in exchange* confusing because they thought that the terminology did not accurately reflect the objective of the valuation premise (ie in both cases the asset is being exchanged, and both cases involve an assessment of how the asset will be used by market participants). In addition, some respondents stated that the in-use valuation premise could be confused with the term *value in use*, as defined in IAS 36.
- BC76 In response, the boards decided to remove the terms *in use* and *in exchange* and instead describe the objective of the valuation premise: the valuation premise assumes that an asset would be used either (a) in combination with other assets or with other assets and liabilities (formerly referred to as *in use*) or (b) on a stand-alone basis (formerly referred to as *in exchange*). Respondents to the FASB's proposed ASU generally supported that proposal. The boards concluded that the change improves the understandability of the valuation premise concept.

Valuation premise for a single non-financial asset

- BC77 IFRS 13 states that the valuation premise assumes that the non-financial asset being measured at fair value is sold on its own (at the unit of account level) and should be measured accordingly, even if transactions in the asset are typically the result of sales of the asset as part of a group of assets or a business. Even when an asset is used in combination with other assets, the exit price for the asset is a price for that asset individually because a fair value measurement assumes that a market participant (buyer) of the asset already holds the complementary assets and the associated liabilities. Because the buyer is assumed to hold the other assets (and liabilities) necessary for the asset to function, that buyer would not be willing to pay more for the asset solely because it was sold as part of a group. That conclusion is consistent with the conclusion reached in IFRS 3 for measuring the fair value of the identifiable assets acquired in a business combination.

Valuation premise for specialised non-financial assets

- BC78 Some respondents to the exposure draft expressed concerns about using an exit price notion for specialised non-financial assets that have a significant value when used together with other non-financial assets, for example in a production process, but have little value if sold for scrap to another market participant that does not have the complementary assets. They were concerned that an exit price would be based on that scrap value (particularly given the requirement to maximise the use of observable inputs, such as market prices) and would not reflect the value that an entity expects to generate by using the asset in its operations. However, IFRS 13 clarifies that this is not the case. In such situations, the scrap value for an individual asset would be irrelevant because the valuation premise assumes that the asset would be used in combination with other assets or with other assets and liabilities. Therefore, an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets and the associated liabilities needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset.
- BC79 It is unlikely in such a situation that a market price, if available, would capture the value that the specialised asset contributes to the business because the market price would be for an unmodified asset. When a market price does not capture the characteristics of the asset (eg if that price represents the use of the asset on a stand-alone basis, not installed or otherwise configured for use, rather than in combination with other assets, installed and configured for use), that price will not represent fair value. In such a situation, an entity will need to measure fair value using another valuation technique (such as an income approach) or the cost to replace or recreate the asset (such as a cost approach) depending on the circumstances and the information available.

Application to liabilities

General principles

- BC80 The exposure draft proposed that a fair value measurement assumes that a liability is transferred to a market participant at the measurement date because the liability that is the subject of the fair value measurement remains outstanding (ie it is owed by the entity and is not settled with the counterparty or otherwise extinguished at the measurement date). Because the liability is assumed to be transferred to a market participant, the liability remains outstanding and the market participant transferee, like the entity, would be required to fulfil it. The same concept applies to an entity's own equity instrument, as discussed in paragraphs BC104–BC107.
- BC81 In many cases, an entity might not intend (or be able) to transfer its liability to a third party. For example, an entity might have advantages relative to the market that would make it more beneficial for the entity to fulfil the liability using its own internal resources or the counterparty might not permit the liability to be transferred to another party. However, the IASB concluded that a fair value measurement provides a market benchmark to use as a basis for assessing an entity's advantages or disadvantages in performance or settlement relative to the market (for both assets and liabilities). Therefore, when a liability is measured at fair value, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before.
- BC82 Furthermore, even if an entity is unable to transfer its liability to a third party, the IASB concluded that the transfer notion was necessary in a fair value measurement because that notion captures market participants' expectations about the liquidity, uncertainty and other factors associated with the liability, whereas a settlement notion may not because it may incorporate entity-specific factors. In the IASB's view, the fair value of a liability from the perspective of a market participant that owes the liability is the same regardless of whether it is settled or transferred. That is because:
- (a) both a settlement and a transfer of a liability reflect all costs that would be incurred to fulfil the obligation, including the market-based profit an entity and a market participant transferee desire to earn on all their activities.
 - (b) an entity faces the same risks when fulfilling an obligation that a market participant transferee faces when fulfilling that obligation. Neither the entity nor the market participant transferee has perfect knowledge about the timing and amount of the cash outflows, even for financial liabilities.
 - (c) a settlement in a fair value measurement does not assume a settlement with the counterparty over time (eg as principal and interest payments become due), but a settlement at the measurement date. Accordingly, the settlement amount in a fair value measurement reflects the present value of the economic benefits (eg payments) the counterparty would have received over time.

As a result, the IASB concluded that similar thought processes are needed to estimate both the amount to settle a liability and the amount to transfer that liability.

- BC83 The exposure draft proposed that an entity could estimate the amount at which a liability could be transferred in a transaction between market participants by using the same methodology that would be used to measure the fair value of the liability held by another entity as an asset (ie the fair value of the corresponding asset). If the liability was traded as an asset, the observed price would also represent the fair value of the issuer's liability. If there was no corresponding asset (eg as would be the case with a decommissioning liability), the fair value of the liability could be measured using a valuation technique, such as the present value of the future cash outflows that market participants would expect to incur in fulfilling the obligation.
- BC84 That proposal was consistent with the approach in Topic 820 in US GAAP (in August 2009, after the IASB's exposure draft was published, the FASB amended Topic 820 to provide additional guidance about measuring the fair value of liabilities). However, Topic 820 provided more guidance than the IASB's exposure draft, including additional examples for applying that guidance. Because the guidance in Topic 820 was consistent with but not identical to the proposals in the IASB's exposure draft, the boards worked together to develop a combination of the two.
- BC85 The boards concluded that the objective of a fair value measurement of a liability when using a valuation technique (ie when there is not an observable market to provide pricing information about the transfer of the liability) is to estimate the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date under current market conditions.
- BC86 Therefore, the boards decided to describe how an entity should measure the fair value of a liability when there is no observable market to provide pricing information about the transfer of a liability. For example, IFRS 13 states that an entity may measure the fair value of a liability by using a quoted price for an identical or a similar liability held by another party as an asset or by using another valuation technique (such as an income approach).
- BC87 The boards clarified that regardless of the approach used, when there is no observable market price for the transfer of a liability and the identical liability is held by another party as an asset, an entity measures the fair value of the liability from the perspective of a market participant that holds the identical liability as an asset at the measurement date. That approach is consistent with the exposure draft and US GAAP.
- BC88 Thus, in the boards' view, the fair value of a liability equals the fair value of a properly defined corresponding asset (ie an asset whose features mirror those of the liability), assuming an exit from both positions in the same market. In reaching their decision, the boards considered whether the effects of illiquidity could create a difference between those values. The boards noted that the effects of illiquidity are difficult to differentiate from credit-related effects. The boards concluded that there was no conceptual reason why the liability value would diverge from the corresponding asset value in the same market because the contractual terms are the same, unless the unit of account for the liability is different from the unit of account for the asset or the quoted price for the asset relates to a similar (but not identical) liability held as an asset.
- BC89 Furthermore, the boards concluded that in an efficient market, the price of a liability held by another party as an asset must equal the price for the corresponding asset. If those prices differed, the market participant transferee (ie the party taking on the obligation) would be able to earn a profit by financing the purchase of the asset with the proceeds received by taking on the liability. In such cases the price for the liability and the price for the asset would adjust until the arbitrage opportunity was eliminated.

- BC90 The exposure draft stated that when using a present value technique to measure the fair value of a liability that is not held by another party as an asset, an entity should include the compensation that a market participant would require for taking on the obligation. Topic 820 contained such a requirement. Respondents asked for clarification on the meaning of compensation that a market participant would require for taking on the obligation. Therefore, the boards decided to provide additional guidance about the compensation that market participants would require, such as the compensation for taking on the responsibility of fulfilling an obligation and for assuming the risk associated with an uncertain obligation (ie the risk that the actual cash outflows might differ from the expected cash outflows). The boards concluded that including this description will improve the application of the requirements for measuring the fair value of liabilities that are not held as assets.
- BC91 Some respondents to the FASB's proposed ASU requested clarification about applying risk premiums when measuring the fair value of a liability that is not held by another party as an asset (eg a decommissioning liability assumed in a business combination) when using a present value technique. They noted that the description of present value techniques described adjustments for risk as *additions* to the discount rate, which they agreed was consistent with asset valuation, but not necessarily consistent with liability valuation in the absence of a corresponding asset. The boards reasoned that from a market participant's perspective, compensation for the uncertainty related to a liability results in an increase to the amount that the market participant would expect to receive for assuming the obligation. If that compensation was accounted for in the discount rate, rather than in the cash flows, it would result in a reduction of the discount rate used in the fair value measurement of the liability. Therefore, the boards concluded that, all else being equal, the risk associated with an asset decreases the fair value of that asset, whereas the risk associated with a liability increases the fair value of that liability. However, the boards decided not to prescribe how an entity would adjust for the risk inherent in an asset or a liability, but to state that the objective is to ensure that the fair value measurement takes that risk into account. That can be done by adjusting the cash flows or the discount rate or by adding a risk adjustment to the present value of the expected cash flows (which is another way of adjusting the cash flows).

Non-performance risk

- BC92 IFRS 13 states that a fair value measurement assumes that the fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation. Non-performance risk includes, but is not limited to, an entity's own credit risk (credit standing). That is consistent with the fair value measurement guidance already in IFRSs. For example, IAS 39* and IFRS 9 referred to making adjustments for credit risk if market participants would reflect that risk when pricing a financial instrument. However, there was inconsistent application of that principle because:
- (a) IAS 39 and IFRS 9 refer to credit risk generally and do not specifically refer to the reporting entity's *own* credit risk; and
 - (b) there were different interpretations about how an entity's own credit risk should be reflected in the fair value of a liability using the settlement notion in the previous definition of fair value because it is unlikely that the counterparty would accept a different amount as settlement of the obligation if the entity's credit standing changed.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC93 As a result, some entities took into account changes in their own credit risk when measuring the fair value of their liabilities, whereas other entities did not. Consequently, the IASB decided to clarify in IFRS 13 that the fair value of a liability includes an entity's own credit risk.
- BC94 In a fair value measurement, the non-performance risk related to a liability is the same before and after its transfer. Although the IASB acknowledges that such an assumption is unlikely to be realistic for an actual transaction (because in most cases the reporting entity transferor and the market participant transferee are unlikely to have the same credit standing), the IASB concluded that such an assumption was necessary when measuring fair value for the following reasons:
- (a) A market participant taking on the obligation would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price (eg a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor if those terms reflect the transferor's lower credit standing).
 - (b) Without specifying the credit standing of the entity taking on the obligation, there could be fundamentally different fair values for a liability depending on an entity's assumptions about the characteristics of the market participant transferee.
 - (c) Those who might hold the entity's obligations as assets would consider the effect of the entity's credit risk and other risk factors when pricing those assets (see paragraphs BC83–BC89).

The FASB reached the same conclusions when developing SFAS 157 and ASU No. 2009-05 *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value*.

- BC95 Few respondents questioned the usefulness of reflecting non-performance risk in the fair value measurement of a liability at initial recognition. However, many questioned the usefulness of doing so after initial recognition, because they reasoned that it would lead to counter-intuitive and potentially confusing reporting (ie gains for credit deterioration and losses for credit improvements). The IASB understands that these concerns are strongly held, but concluded that addressing them was beyond the scope of the fair value measurement project. The purpose of that project was to define fair value, not to determine when to use fair value or how to present changes in fair value. A measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement. The IASB addressed those concerns in developing IFRS 9 (issued in October 2010).

Liabilities issued with third-party credit enhancements

- BC96 IFRS 13 includes requirements for measuring the fair value of a liability issued with an inseparable third-party credit enhancement from the issuer's perspective. Those requirements are consistent with Topic 820.
- BC97 A credit enhancement (also referred to as a guarantee) may be purchased by an issuer that combines it with a liability, such as debt, and then issues the combined security to an investor. For example, debt may be issued with a financial guarantee from a third party that guarantees the issuer's payment obligations. Generally, if the issuer of the liability fails to meet its payment obligations to the investor, the guarantor has an obligation to make the payments on the issuer's behalf and the issuer has an

obligation to the guarantor. By issuing debt combined with a credit enhancement, the issuer is able to market its debt more easily and can either reduce the interest rate paid to the investor or receive higher proceeds when the debt is issued.

- BC98 The boards concluded that the measurement of a liability should follow the unit of account of the liability for financial reporting purposes. When the unit of account for such liabilities is the obligation without the credit enhancement, the fair value of the liability from the issuer's perspective will not equal its fair value as a guaranteed liability held by another party as an asset. Therefore, the fair value of the guaranteed liability held by another party as an asset would need to be adjusted because any payments made by the guarantor in accordance with the guarantee result in a transfer of the issuer's debt obligation from the investor to the guarantor. The issuer's resulting debt obligation to the guarantor has not been guaranteed. Consequently, the boards decided that if the third-party credit enhancement is accounted for separately from the liability, the fair value of that obligation takes into account the credit standing of the issuer and not the credit standing of the guarantor.

Restrictions preventing transfer

- BC99 A restriction on an entity's ability to transfer its liability to another party is a function of the requirement to fulfil the obligation and the effect of such a restriction normally is already reflected in the price. As a result, IFRS 13 states that the fair value of a liability should not be adjusted further for the effect of a restriction on its transfer if that restriction is already included in the other inputs to the fair value measurement. However, if an entity is aware that a restriction on transfer is not already reflected in the price (or in the other inputs used in the measurement), the entity would adjust those inputs to reflect the existence of the restriction.
- BC100 The boards concluded that there are two fundamental differences between the fair value measurement of an asset and the fair value measurement of a liability that justify different treatments for asset restrictions and liability restrictions. First, restrictions on the transfer of a liability relate to the performance of the obligation (ie the entity is legally obliged to satisfy the obligation and needs to do something to be relieved of the obligation), whereas restrictions on the transfer of an asset relate to the marketability of the asset. Second, nearly all liabilities include a restriction preventing the transfer of the liability, whereas most assets do not include a similar restriction. As a result, the effect of a restriction preventing the transfer of a liability, theoretically, would be consistent for all liabilities and, therefore, would require no additional adjustment beyond the factors considered in determining the original transaction price. The inclusion of a restriction preventing the sale of an asset typically results in a lower fair value for the restricted asset than for the non-restricted asset, all other factors being equal.

Measurement of financial liabilities with a demand feature*

- BC101 In developing IFRS 13, the IASB confirmed its decision in developing IAS 39 that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be repaid.
- BCZ102 Some comments received on the exposure draft published in 2002 preceding IAS 39 requested clarification of how to measure the fair value of financial liabilities with a demand feature (eg demand deposits) when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the demand amount), such as the

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amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believed that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.

BCZ103 In developing IAS 39 the IASB agreed that this issue should be clarified. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (this is now in paragraph 47 of IFRS 13). That conclusion is the same as in the original IAS 32 *Financial Instruments: Disclosure and Presentation* (issued by the IASB's predecessor body, IASC, in 1995), which is now IAS 32 *Financial Instruments: Presentation*. The IASB noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—ie the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the IASB believes is inappropriate.

Application to an entity's own equity instruments*

BC104 The exposure draft and Topic 820 stated that although the definition of fair value refers to assets and liabilities, it also should be applied to an instrument measured at fair value that is classified in an entity's own shareholders' equity. Respondents to the discussion paper asked for explicit guidance for measuring the fair value of such instruments because Topic 820 did not contain explicit guidance. Consequently, the boards decided to describe how an entity should measure the fair value of its own equity instruments (eg when an acquirer issues equity in consideration for an acquiree in a business combination).

BC105 The exposure draft proposed requiring an entity to measure the fair value of its own equity instruments from the perspective of a market participant that holds the instrument as an asset. That was because the issuer of an equity instrument can exit from that instrument only if the instrument ceases to exist or if the entity repurchases the instrument from the holder. The FASB agreed with that conclusion.

BC106 The boards also noted that some instruments may be classified as liabilities or equity, depending on the characteristics of the transaction and the characteristics of the instrument. Examples of such instruments include contingent consideration issued in a business combination in accordance with IFRS 3 and equity warrants issued by an entity in accordance with IAS 39^{*} or IFRS 9. The boards concluded that the requirements for measuring the fair value of an entity's own equity instruments should be consistent with the requirements for measuring the fair value of liabilities. Consequently, the boards decided to clarify that the accounting classification of an instrument should not affect that instrument's fair value measurement.

BC107 The boards decided to clarify that the objective of a fair value measurement for liabilities and an entity's own equity instruments should be an exit price from the perspective of a market participant that holds the instrument as an asset at the measurement date if there is a corresponding asset, regardless of whether there is an observable market for the instrument as an asset. That decision is consistent with the boards' decisions about the requirements for measuring the fair value of a liability.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk*

- BC108 An entity that holds a group of financial assets and financial liabilities is exposed to market risks (ie interest rate risk, currency risk or other price risk) and to the credit risk of each of the counterparties. Financial institutions and similar entities that hold financial assets and financial liabilities often manage those instruments on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty.
- BC109 The previous requirements in IFRSs and US GAAP for measuring the fair value of financial assets and financial liabilities that are managed in this way were expressed differently. Therefore, the boards concluded that it is important that IFRSs and US GAAP express the requirements for measuring the fair value of those financial instruments in the same way.
- BC110 When applying IFRSs, entities applied IFRS 9 or IAS 39, which permitted an entity to take into account the effects of offsetting positions in the same market risk (or risks) when measuring the fair value of a financial asset or financial liability. Many entities were using the same approach for offsetting positions in the credit risk of a particular counterparty by analogy.
- BC111 When applying US GAAP, many entities applied the in-use valuation premise when measuring the fair value of such financial assets and financial liabilities. In other words, an entity would take into account how the fair value of each financial asset or financial liability might be affected by the combination of that asset or liability with other financial assets or financial liabilities held by the entity. Other entities applied the in-exchange valuation premise to the entity's net risk exposure and assumed that the transaction took place for the net position, not for the individual assets and liabilities making up that position. Those differing applications of the valuation premise arose because Topic 820 did not specify the valuation premise for financial assets.
- BC112 In developing the exposure draft, the IASB concluded that the fair value of a financial asset reflects any benefits that market participants would derive from holding that asset within a diversified portfolio. An entity derives no incremental value from holding a financial asset within a portfolio. Furthermore, the IASB noted that the valuation premise related only to assets, not to liabilities, and as such could not be applied to portfolios of financial instruments that include financial liabilities. Therefore, the exposure draft proposed that the in-exchange valuation premise must be used to measure the fair value of a financial asset. The IASB also proposed an amendment to IAS 39 making it explicit that the unit of account for financial instruments is the individual financial instrument at all levels of the fair value hierarchy (Level 1, 2 or 3).
- BC113 The boards understand that although the approaches used to measure the fair value of financial assets and financial liabilities were expressed differently in IFRSs and US GAAP, they resulted in similar fair value measurement conclusions in many cases. However, the FASB was aware that before the amendments Topic 820 was sometimes interpreted more broadly than the FASB intended, such as when an entity used the in-use valuation premise to measure the fair value of a group of financial assets when the entity did not have offsetting positions in a particular market risk (or risks) or counterparty credit risk. That interpretation led the IASB to propose requiring the in-exchange valuation premise for financial assets in its exposure draft.

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- BC114 The IASB's proposal to require the fair value of a financial asset to be measured using the in-exchange valuation premise was one of the more controversial proposals in the exposure draft. That proposal, combined with a proposed amendment to IAS 39 about the unit of account for financial instruments, led respondents to believe that the fair value of financial assets cannot reflect the fact that those assets are held within a portfolio, even when an entity manages its financial instruments on the basis of the entity's net exposure, rather than its gross exposure, to market risks and credit risk.
- BC115 Respondents were concerned that the proposal in the exposure draft would separate the valuation of financial instruments for financial reporting from the entity's internal risk management practices. In addition, they were concerned about the systems changes that would be necessary to effect a change in practice. To preserve the relationship between financial reporting and risk management, some respondents asked whether they would be able to apply the bid-ask spread guidance to each of the individual instruments so that the sum of the fair values of the individual instruments equals the value of the net position.
- BC116 Other respondents suggested that the IASB should continue to allow the practice that has developed using paragraph AG72 of IAS 39, which stated:
- When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate.
- BC117 The previous requirements in IFRSs and US GAAP did not clearly specify the relationship between the fair value measurement of financial instruments and how an entity manages its net risk exposure. For example, Topic 820, IAS 39 and IFRS 9 did not explicitly address how the following meet the objective of a fair value measurement for financial instruments:
- (a) Entities typically do not manage their exposure to market risks and credit risk by *selling* a financial asset or transferring a financial liability (eg by unwinding a transaction). Instead, they manage their risk exposure by entering into a transaction for another financial instrument (or instruments) that would result in an offsetting position in the same risk. The resulting measurement represents the fair value of the net risk exposure, not the fair value of an individual financial instrument. The sum of the fair values of the individual instruments is not equal to the fair value of the net risk exposure.
 - (b) An entity's net risk exposure is a function of the other financial instruments held by the entity and of the entity's risk preferences (both of which are entity-specific decisions and, thus, do not form part of a fair value measurement). Market participants may hold different groups of financial instruments or may have different risk preferences, and it is those factors that are taken into account when measuring fair value. However, the boards understand that market participants holding that particular group of financial instruments and with those particular risk preferences would be likely to price those financial instruments similarly (ie using similar valuation techniques and similar market data). As a result, the market participants' measurement of those financial instruments within that particular group is a market-based measurement, and a measurement using an entity's risk preferences would not be a fair value measurement, but an entity-specific measurement.

- BC118 Consequently, the boards decided to permit an exception to the requirements in IFRS 13 and Topic 820 for measuring fair value when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or to the credit risk of a particular counterparty. Respondents to the FASB's proposed ASU generally supported that proposal and stated that it was consistent with current practice for measuring the fair value of such financial assets and financial liabilities.
- BC119 That exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie asset) for a particular risk exposure or to transfer a net short position (ie liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions, subject to specific requirements.

Scope of paragraph 52

- BC119A After issuing IFRS 13, the IASB was made aware that it was not clear whether the scope of the exception for measuring the fair value of a group of financial assets and financial liabilities on a net basis (the 'portfolio exception') includes all contracts that are within the scope of IAS 39 or IFRS 9. The exception is set out in paragraph 48 and the scope of the exception is set out in paragraph 52. In particular, the IASB was asked whether the scope of the portfolio exception included contracts that are accounted for as if they were financial instruments, but that do not meet the definitions of financial assets or financial liabilities in IAS 32. Examples of such a situation would be some contracts to buy or sell a non-financial item that can be settled net in cash by another financial instrument or by exchanging financial instruments as if the contracts were financial instruments within the scope of, and accounted for in accordance with, IAS 39 or IFRS 9.
- BC119B The IASB did not intend to exclude from the scope of the portfolio exception any contracts that are within the scope of IAS 39 or IFRS 9. Consequently, the IASB amended paragraph 52 of this Standard to clarify that the portfolio exception applies to all contracts within the scope of, and accounted for in accordance with, IAS 39 or IFRS 9, regardless of whether they meet the definitions of financial assets or financial liabilities as defined in IAS 32.

Evidence of managing financial instruments on the basis of the net risk exposure

- BC120 IFRS 13 states that to use the exception, an entity must provide evidence that it consistently manages its financial instruments on the basis of its net exposure to market risks or credit risk. In addition, the entity must be required (or must have elected, for example, in accordance with the fair value option) to measure the financial instruments at fair value on a recurring basis. The boards concluded that if an entity does not manage its risk exposure on a net basis and does not manage its financial instruments on a fair value basis, the entity should not be permitted to measure the fair value of its financial instruments on the basis of the entity's net risk exposure.

- BC121 The boards decided to require an entity to provide evidence that it manages its net risk exposure consistently from period to period. The boards decided this because an entity that can provide evidence that it manages its financial instruments on the basis of its net risk exposure would do so consistently for a particular portfolio from period to period, and not on a net basis for that portfolio in some periods and on a gross basis in other periods. Some respondents to the FASB's proposed ASU found that requirement limiting because they noted that the composition of a portfolio changes continually as the entity rebalances the portfolio and changes its risk exposure preferences over time. Although the entity does not need to maintain a static portfolio, the boards decided to clarify that the entity must make an accounting policy decision (in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) to use the exception described in paragraphs BC118 and BC119. The boards also decided that the accounting policy decision could be changed if the entity's risk exposure preferences change. In that case the entity can decide not to use the exception but instead to measure the fair value of its financial instruments on an individual instrument basis. However, if the entity continues to value a portfolio using the exception, it must do so consistently from period to period.

Exposure to market risks

- BC122 The boards decided that an entity could apply the bid-ask spread guidance to the entity's net position in a particular market risk (rather than to each individual financial instrument included in that position) only if the market risks that are being offset are substantially the same. Some respondents to the FASB's proposed ASU asked for additional guidance on what is meant by *substantially the same* given the different instruments and types of instruments that might make up a portfolio. In addition, they were concerned that the proposed requirement that the market risks be substantially the same meant that there could be no basis risk in the portfolio or, conversely, that the basis risk would not be reflected in the fair value measurement.
- BC123 Consequently, the boards decided to include additional guidance for determining whether market risks are substantially the same. The boards held discussions with several financial institutions that manage their financial assets and financial liabilities on the basis of their net exposure to market risks. From those discussions, the boards concluded that when measuring fair value on the basis of an entity's net exposure to market risks, the entity should not combine a financial asset that exposes it to a particular market risk with a financial liability that exposes it to a different market risk that does not mitigate either of the market risk exposures that the entity faces. The boards also concluded that it is not necessary that the grouping of particular financial assets and financial liabilities results in an entity having no basis risk because the fair value measurement would take into account any basis risk. Furthermore, on the basis of their discussions with financial institutions, the boards concluded that an entity should not combine a financial asset that exposes it to a particular market risk over a particular duration with a financial liability that exposes it to substantially the same market risk over a different duration without taking into account the fact that the entity is fully exposed to that market risk over the time period for which the market risks are not offset. If there is a time period in which a market risk is not offset, the entity may measure its net exposure to that market risk over the time period in which the market risk is offset and must measure its gross exposure to that market risk for the remaining time period (ie the time period in which the market risk is not offset).

Exposure to the credit risk of a particular counterparty

- BC124 Because the bid-ask spread (which is the basis for making adjustments for an entity's exposure to market risk to arrive at the fair value of the net position) does not include adjustments for counterparty credit risk (see paragraph BC164), the boards decided to specify that an entity may take into account its net exposure to the credit risk of a particular counterparty when applying the exception.
- BC125 The boards decided that when measuring fair value, an entity may consider its net exposure to credit risk when it has entered into an arrangement with a counterparty that mitigates its credit risk exposure in the event of default (eg a master netting agreement). On the basis of their discussions with financial institutions the boards concluded that a fair value measurement reflects market participants' expectations about the likelihood that such an arrangement would be legally enforceable.
- BC126 Some respondents to the FASB's proposed ASU asked whether the existence of a master netting agreement was necessary or whether other credit mitigating arrangements could be taken into account in the fair value measurement. The boards decided to clarify that in a fair value measurement, an entity must take into account other arrangements that mitigate credit risk, such as an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party, if market participants would expect such arrangements to be legally enforceable in the event of default.
- BC127 The boards acknowledged that the group of financial assets and financial liabilities for which an entity manages its net exposure to a particular market risk (or risks) could differ from the group of financial assets and financial liabilities for which an entity manages its net exposure to the credit risk of a particular counterparty because it is unlikely that all contracts would be with the same counterparty.

Relationship between measurement and presentation

- BC128 In some cases the basis for the presentation of financial instruments in the statement of financial position differs from the basis for the measurement of those financial instruments. For example, that would be the case if an IFRS does not require or permit financial instruments to be presented on a net basis. The FASB's proposed ASU stated that the exception would not apply to financial statement presentation (ie an entity must comply with the financial statement presentation requirements specified in other standards).
- BC129 The boards discussed the different approaches to measurement and presentation, particularly in the light of their currently differing requirements for offsetting financial assets and financial liabilities. In IAS 32 an entity may not use net presentation unless specific criteria are met, whereas in US GAAP many entities are able to use net presentation in their financial statements. However, the criteria for net presentation in US GAAP relate to credit risk, not to market risks. As a result, the presentation and measurement bases are different when an entity applies bid-ask adjustments on a net basis but is required to present fair value information on a gross basis (although generally the financial instruments with bid-ask adjustments would qualify for net presentation in US GAAP because of the existence of master netting agreements and other credit risk mitigating arrangements).
- BC130 The boards concluded that a relationship between presentation and measurement is not necessary and that adjustments for market risks or credit risk (ie portfolio-level adjustments) are a matter of measurement rather than presentation. They reasoned that fair value measurements are meant to reflect (a) the risk exposure faced by the entity and (b) how that risk exposure would be priced by market participants (which is one reason the boards decided to permit the exception; see paragraph BC117). When pricing financial instruments, a market participant would take into account the other instruments it holds to the extent that those instruments reduce or enhance its overall risk exposure. That is a consequence of requiring or permitting financial instruments to be measured at fair value. The boards' considerations for requiring net or gross presentation of financial instruments are different from those for requiring net or gross measurement.
- BC131 Some respondents asked for additional guidance for allocating the bid-ask and credit adjustments to the individual assets and liabilities that make up the group of financial assets and financial liabilities. Although any allocation method is inherently subjective, the boards concluded that a quantitative allocation would be appropriate if it was reasonable and consistently applied. Therefore, the boards decided not to require a particular method of allocation.

Fair value at initial recognition*

- BC132 The exposure draft proposed guidance for measuring fair value at initial recognition, using both observable and unobservable inputs (as appropriate). The exposure draft also proposed a list of indicators specifying when the transaction price might not be the best evidence of the fair value of an asset or a liability at initial recognition.
- BC133 Respondents generally agreed with the list of indicators, but thought that the wording used implied that those were the only indicators, rather than examples of indicators. They suggested that the IFRS on fair value measurement should use the wording in US GAAP. The boards agreed with respondents that the list of indicators was not exhaustive and decided to use the wording in Topic 820.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC134 Some respondents suggested that market inactivity should be included in the list of indicators. The boards concluded that market inactivity is not an indicator that the transaction price may not represent fair value, but an indicator that the entity should do further work to determine whether the transaction price represents fair value.
- BC135 The exposure draft did not address the recognition of a day 1 gain or loss but stated that an entity would recognise such gains or losses unless another IFRS specifies otherwise. For example, IAS 39 and IFRS 9 state that an entity cannot recognise a day 1 gain or loss for a financial instrument unless its fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets. In contrast, IFRS 3 and IAS 41 require the recognition of day 1 gains or losses even when fair value is measured using unobservable inputs.
- BC136 The IASB concluded that fair value should be measured at initial recognition without regard to whether it would result in a gain or loss at initial recognition of the asset or liability. Respondents' views ranged from the view that the transaction price is the best evidence of fair value at initial recognition unless the fair value is measured using only observable inputs (the approach in IAS 39 and IFRS 9) to the view that the transaction price might sometimes, but not always, represent fair value at initial recognition, and that the degree of observability of inputs is not always the best indicator of whether this is the case (the approach in US GAAP).
- BC137 Many respondents suggested that IFRSs and US GAAP should have the same requirements for recognising gains or losses at initial recognition. The boards concluded that determining whether to recognise a day 1 gain or loss was beyond the scope of the fair value measurement project. The boards noted that the measurement basis at initial recognition of financial instruments in IFRSs and US GAAP is not always the same, and so the boards could not address comparability at this time. As a result, the boards decided that an entity would refer to relevant IFRSs for the asset or liability when determining whether to recognise those amounts. The boards concluded that if the relevant IFRS does not specify whether and, if so, where to recognise those amounts, the entity should recognise them in profit or loss.
- BC138 Although the IASB did not change the recognition threshold, it amended IAS 39* and IFRS 9 to clarify that the fair value of financial instruments at initial recognition should be measured in accordance with IFRS 13 and that any deferred amounts arising from the application of the recognition threshold in IAS 39 and IFRS 9 are separate from the fair value measurement. In other words, the recognition threshold in IAS 39 and IFRS 9 is not a constraint when measuring fair value. Rather, it determines whether (and when) the resulting difference (if any) between fair value at initial recognition and the transaction price is recognised.

Short-term receivables and payables

- BC138A After issuing IFRS 13, the IASB was made aware that an amendment to IFRS 9 and IAS 39, which resulted in the deletion of paragraphs B5.4.12 and AG79 respectively, might be perceived as removing the ability to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial. The IASB did not intend to change the measurement requirements for those short-term receivables and payables, noting that paragraph 8 of IAS 8 already permits entities not to apply accounting policies set out in accordance with IFRSs when the effect of applying them is immaterial.

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Valuation techniques

- BC139 When measuring fair value, the objective of using a valuation technique is to estimate the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions.
- BC140 To meet that objective, the exposure draft proposed that valuation techniques used to measure fair value should be consistent with the market approach, income approach or cost approach. Such valuation techniques are consistent with those already described in IFRSs and with valuation practice.
- BC141 Respondents generally agreed with the descriptions of the three valuation techniques. Some respondents questioned whether a cost approach is consistent with an exit price definition of fair value because they think that the cost to replace an asset is more consistent with an entry price than an exit price. The IASB noted that an entity's cost to replace an asset would equal the amount that a market participant buyer of that asset (that would use it similarly) would pay to acquire it (ie the entry price and the exit price would be equal in the same market). Thus, the IASB concluded that the cost approach is consistent with an exit price definition of fair value.

Single versus multiple valuation techniques

- BC142 IFRS 13 does not contain a hierarchy of valuation techniques because particular valuation techniques might be more appropriate in some circumstances than in others. The IASB concluded that determining the appropriateness of valuation techniques in the circumstances requires judgement and noted that Topic 820 and the fair value measurement guidance already in IFRSs do not contain a hierarchy of valuation techniques. For example, IAS 41 acknowledged that in some cases the various approaches used by an entity might suggest different fair value conclusions for a biological asset or agricultural produce, but that the entity should consider the reasons for the differences to arrive at a fair value within a reasonable range.

Valuation adjustments

- BC143 Some respondents asked for more explicit requirements about applying valuation adjustments (including risk adjustments related to the uncertainty inherent in the inputs used in a fair value measurement; see paragraphs BC149 and BC150). They found the descriptions of valuation adjustments in the IASB's Fair Value Expert Advisory Panel's October 2008 report *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* helpful (see paragraph BC177). In addition, regulators asked the IASB to address measurement uncertainty to ensure that fair value measurements are not overstated or understated in the statement of financial position, thus improving the quality of information available to users of financial statements.
- BC144 Although the exposure draft was not explicit with respect to valuation adjustments, it stated that an entity must use the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique or in the inputs to the valuation technique. That implicitly included measurement uncertainty.

BC145 The boards noted that entities found the IASB's Fair Value Expert Advisory Panel's report helpful when measuring the fair value of financial instruments during a period of market inactivity. As a result, the boards decided to describe the valuation adjustments that entities might need to make when using a valuation technique because market participants would make those adjustments when pricing a financial asset or financial liability under the market conditions at the measurement date, including adjustments for measurement uncertainty. Those valuation adjustments include the following:

- (a) an adjustment to a valuation technique to take into account a characteristic of an asset or a liability that is not captured by the valuation technique (the need for such an adjustment is typically identified during calibration of the value calculated using the valuation technique with observable market information).

- (b) applying the point within the bid-ask spread that is most representative of fair value in the circumstances.
- (c) an adjustment to take into account non-performance risk (eg an entity's own credit risk or the credit risk of the counterparty to a transaction).
- (d) an adjustment to take into account measurement uncertainty (eg when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value).

BC146 The boards decided that it would be appropriate to apply such valuation adjustments if those adjustments are consistent with the objective of a fair value measurement. Valuation adjustments may help avoid an understatement or overstatement of a fair value measurement and should be applied when a valuation technique or the inputs to a valuation technique do not capture factors that market participants would take into account when pricing an asset or a liability at the measurement date, including assumptions about risk.

Consistency constraint

BC147 IFRS 13 emphasises the need for consistency in the valuation technique or techniques used to measure fair value. It does not preclude a change in valuation technique, provided that the change results in a measurement that is equally or more representative of fair value in the circumstances. The exposure draft proposed requiring an entity to disclose the effect of a change in valuation technique on a fair value measurement (similar to the disclosures required by IAS 8 for a change in valuation technique). Respondents did not support that proposal because they thought it would be difficult to determine whether a change in fair value was attributable to a change in the valuation technique used or attributable to changes in other factors (such as changes in the observability of the inputs used in the measurement).

BC148 The IASB agreed with those respondents and decided that in the absence of an error (eg in the selection or application of a particular valuation technique), revisions resulting from a change in the valuation technique or its application should be accounted for as a change in accounting estimate in accordance with IAS 8. The IASB concluded that disclosing the effect of a change in valuation technique on the fair value measurement or requiring the disclosures in IAS 8 for a change in accounting estimate would not be cost-beneficial.

Inputs to valuation techniques

Assumptions about risk

BC149 In IFRS 13 inputs refer broadly to the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. The IASB decided that a necessary input to a valuation technique is an adjustment for risk because market participants would make such an adjustment when pricing an asset or a liability. Therefore, including an adjustment for risk ensures that the measurement reflects an exit price for the asset or liability, ie the price that would be received in an orderly transaction to sell an asset or paid in an orderly transaction to transfer the liability at the measurement date under current market conditions.

BC150 The IASB accepted that it might be difficult for an entity to quantify a risk adjustment in some cases, but concluded that this difficulty does not justify the exclusion of this input if market participants would take it into account. The exposure draft focused on the need to adjust for the risk inherent in a particular valuation technique used to measure fair value, such as a pricing model (model risk) and the risk inherent in the inputs to the valuation technique (input risk). That proposal was consistent with US GAAP.

Observable and unobservable inputs

BC151 IFRS 13 distinguishes between observable inputs and unobservable inputs, and requires an entity to maximise the use of relevant observable inputs and minimise the use of unobservable inputs (consistently with the fair value measurement guidance that was already in IFRSs). Respondents to the exposure draft expressed concerns about being required to use observable inputs during the global financial crisis that started in 2007 when the available observable inputs were not representative of the asset or liability being measured at fair value. Given that feedback, the IASB wanted to ensure that observability was not the only criterion applied when selecting the inputs to a valuation technique. Consequently, IFRS 13 focuses on *relevant* observable inputs because the IASB noted that in some cases the available observable inputs will require an entity to make significant adjustments to them given the characteristics of the asset or liability and the circumstances at the measurement date (eg market conditions).

Application of premiums and discounts in a fair value measurement

BC152 The exposure draft proposed an amendment to IAS 39* making it explicit that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy. That proposal in effect would have prohibited the application of premiums and discounts related to the size of an entity's holding in a fair value measurement categorised within any level of the fair value hierarchy for financial instruments within the scope of IAS 39. The IASB proposed that amendment for the following reasons:

- (a) The unit of account for a financial instrument should not depend on an instrument's categorisation within the fair value hierarchy.
- (b) Market participants will enter into a transaction to sell a financial instrument that maximises the fair value of an asset or minimises the fair value of a liability. An entity's decision to sell at a less advantageous price because it sells an entire holding rather than each instrument individually is a factor specific to that reporting entity.

BC153 Before the amendments to Topic 820, US GAAP generally prohibited any adjustment to a quoted price in an active market for an identical asset or liability for a fair value measurement categorised within Level 1 of the fair value hierarchy (including either a blockage factor, which was described as an adjustment to a quoted price for an asset or a liability when the normal daily trading volume for the asset or liability is not sufficient to absorb the quantity held and therefore placing orders to sell the asset or liability in a single transaction might affect the quoted price, or any other premium or discount). However, Topic 820 did not specify whether a blockage factor (or another premium or discount, such as a control premium or a non-controlling interest discount) should be applied in a fair value measurement categorised within Level 2 or Level 3 of the fair value hierarchy if market participants would take it into account when pricing the asset or liability.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC154 Respondents interpreted the proposal in the exposure draft as being consistent with Topic 820 for fair value measurements categorised within Level 1 of the fair value hierarchy, but they thought it was inconsistent with Topic 820 for fair value measurements categorised within Level 2 and Level 3. For example, some respondents thought that the IASB intended to prohibit the application of any premiums or discounts (such as a control premium) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy even when market participants would take into account a premium or discount when pricing the asset or liability for a particular unit of account.
- BC155 Some respondents supported the proposal for fair value measurements categorised within Level 1 of the fair value hierarchy even though, in their view, entities do not typically exit a position on an individual instrument basis (eg by entering into a transaction to sell a single share of equity). Those respondents understood the boards' concerns about verifiability within Level 1. Other respondents stated that the fair value measurement should reflect the fair value of the entity's *holding*, not of each individual instrument within that holding (ie they did not agree that the unit of account for a financial instrument should be a single instrument). Those respondents maintained that the principle should be that the unit of account reflects how market participants would enter into a transaction for the asset or liability. They asserted that market participants would not (and often cannot) sell individual items. The FASB received similar comments when developing SFAS 157. The boards concluded that such concerns were outside the scope of the fair value measurement project because the project addressed *how* to measure fair value and not *what* is measured at fair value.
- BC156 In addition, the comments received on the exposure draft indicated that respondents had different interpretations of the term *blockage factor*. Many respondents interpreted a blockage factor as any adjustment made because of the size of an asset or a liability. In the boards' view, there is a difference between size being a characteristic of the asset or liability and size being a characteristic of the entity's holding. Accordingly, the boards clarified that a blockage factor encompasses the latter and is not relevant in a fair value measurement because a fair value measurement reflects the value of the asset or liability to a market participant for a particular unit of account and is not necessarily representative of the value of the entity's entire holding.
- BC157 Given the description of a blockage factor, the boards concluded that an entity's decision to realise a blockage factor is specific to that entity, not to the asset or liability. In many cases the unit of account for a financial instrument for financial reporting is the individual financial instrument. In such cases the size of an entity's holding is not relevant in a fair value measurement. An entity would realise a blockage factor when that entity decides to enter into a transaction to sell a block consisting of a large number of identical assets or liabilities. Therefore, blockage factors are conceptually similar to transaction costs in that they will differ depending on how an entity enters into a transaction for an asset or a liability. The boards concluded that if an entity decides to enter into a transaction to sell a block, the consequences of that decision should be recognised when the decision is carried out regardless of the level of the fair value hierarchy in which the fair value measurement is categorised.
- BC158 Therefore, the boards decided to clarify that the application of premiums and discounts in a fair value measurement is related to the characteristics of the asset or liability being measured at fair value and its unit of account. IFRS 13 specifies that when a Level 1 input is not available, a fair value measurement should incorporate premiums or discounts if market participants would take them into account in a transaction for the asset or liability. Paragraph BC168 describes the IASB's rationale for requiring an entity to use Level 1 inputs without adjustment whenever available. However, the boards decided to clarify that the application of premiums or

discounts must be consistent with the unit of account in the IFRS that requires or permits the fair value measurement.

- BC159 The boards decided not to provide detailed descriptions of premiums and discounts or to provide detailed guidance about their application in a fair value measurement. They reasoned that such descriptions and guidance would be too prescriptive because the application of premiums and discounts in a fair value measurement depends on the facts and circumstances at the measurement date. In the boards' view, different facts and circumstances might lead to particular premiums or discounts being relevant for some assets and liabilities but not for others (eg in different jurisdictions). Furthermore, the boards did not intend to preclude the use of particular premiums or discounts, except for blockage factors.

Inputs based on bid and ask prices

- BC160 In some situations, inputs might be determined on the basis of bid and ask prices, eg an input from a dealer market, in which the bid price represents the price the dealer is willing to pay and the ask price represents the price at which the dealer is willing to sell. IAS 39 required the use of bid prices for asset positions and ask prices for liability positions. IAS 36 and IAS 38 *Intangible Assets* had similar requirements.
- BC161 The exposure draft proposed that a fair value measurement should use the price within the bid-ask spread that is most representative of fair value in the circumstances. Furthermore, the exposure draft stated that the bid-ask spread guidance applied at all levels of the fair value hierarchy, when bid and ask prices are relevant (see paragraph BC165), and did not preclude the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient.
- BC162 Many respondents supported the proposal because in their experience different market participants enter into transactions at different prices within a bid-ask spread. Some respondents preferred a single bid-ask spread pricing method, as described in IAS 39, because it would maximise the consistency and comparability of fair value measurements using bid and ask prices.
- BC163 The IASB observed that, in many situations, bid and ask prices establish the boundaries within which market participants would negotiate the price in the exchange for the asset or liability. Having clarified the fair value measurement objective, the IASB concluded that an entity should use judgement in meeting that objective. Accordingly, IFRS 13 states that a fair value measurement should use the price within the bid-ask spread that is most representative of fair value in the circumstances, and that the use of bid prices for asset positions and ask prices for liability positions is permitted but is not required.
- BC164 IAS 39 stated that the *bid-ask spread* includes only transaction costs. In IAS 39 other adjustments to arrive at fair value (eg for counterparty credit risk) were not included in the term *bid-ask spread*. Some respondents asked whether the proposed bid-ask guidance reflected that view. Although the boards decided not to specify what, if anything, is in a bid-ask spread besides transaction costs, in the boards' view the bid-ask spread does not include adjustments for counterparty credit risk (see paragraphs BC124–BC127 for a discussion on adjustments for counterparty credit risk when measuring fair value). Therefore, an entity will need to make an assessment of what is in the bid-ask spread for an asset or a liability when determining the point within the bid-ask spread that is most representative of fair value in the circumstances.
- BC165 Some respondents noted that there could be a difference between entry prices and exit prices when entities enter into transactions at different points within the bid-ask spread. For example, an entity might buy an asset at the ask price (entry price) and measure fair value using the bid price (exit price). The boards concluded that bid-ask spreads are only relevant for financial instruments and in markets in which an intermediary (eg a broker) is necessary to bring together a buyer and a seller to engage in a transaction (ie when the buyer and seller need an intermediary to find one

another). When measuring the fair value of a non-financial asset or non-financial liability, the notion of a bid-ask spread will not be relevant because the buyers and sellers in the principal (or most advantageous) market have already found one another and are assumed to have negotiated the transaction price (ie fair value).

Fair value hierarchy

BC166 IFRS 13 uses a three-level fair value hierarchy, as follows:

- (a) Level 1 comprises unadjusted quoted prices in active markets for identical assets and liabilities.
- (b) Level 2 comprises other observable inputs not included within Level 1 of the fair value hierarchy.
- (c) Level 3 comprises unobservable inputs (including the entity's own data, which are adjusted if necessary to reflect the assumptions market participants would use in the circumstances).

BC167 The IASB noted that many IFRSs already contained an implicit fair value hierarchy by referring to observable market transactions or measuring fair value using a valuation technique. For example, the following three-level measurement hierarchy was implicit in IAS 39 and IFRS 9:

- (a) financial instruments quoted in an active market;
- (b) financial instruments whose fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets; and
- (c) financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data.

Level 1 inputs

BC168 Level 1 inputs are unadjusted quoted prices in active markets for identical assets and liabilities. The IASB concluded that those prices generally provide the most reliable evidence of fair value and should be used to measure fair value whenever available.

BC169 IFRS 13 defines an active market as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. The IASB concluded that although different words are used, that definition is consistent with the definitions of an active market already in IFRSs:

- (a) IASs 36, 38 and 41 stated that an active market is one in which ‘(i) the items traded in the market are homogeneous; (ii) willing buyers and sellers can normally be found at any time; and (iii) prices are available to the public.’
- (b) IAS 39 and IFRS 9 stated that an active market is one in which ‘quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis.’

BC170 IFRS 13 states that when an entity holds a large number of similar assets and liabilities that are required to be measured at fair value and a quoted price in an active market is not readily accessible for each of those assets and liabilities, the entity can use an alternative pricing method that does not rely exclusively on quoted prices as a practical expedient (although the resulting fair value measurement is a lower level measurement). For example, an entity might hold a large number of similar debt instruments (such as sovereign debt securities) and use matrix pricing, which does not rely exclusively on quoted prices, to measure the fair value of those instruments. In such a situation, although a Level 1 input is used to measure fair value, the fair value measurement would not be categorised within Level 1 of the fair value hierarchy. That is a departure from the principle that a fair value measurement should maximise the use of relevant observable inputs. However, the IASB regards this particular practical expedient as justified on cost-benefit grounds.

Level 2 inputs

BC171 Level 2 inputs are all inputs other than quoted prices included in Level 1 that are observable (either directly or indirectly) for the asset or liability. The IASB concluded that it is appropriate to include in Level 2 market-corroborated inputs that might not be directly observable, but are based on or supported by observable market data, because such inputs are less subjective than unobservable inputs classified within Level 3.

Level 3 inputs

BC172 Level 3 inputs are unobservable inputs for the asset or liability.

BC173 Some respondents stated that it would be misleading to describe a measurement using significant unobservable inputs as a fair value measurement. They also expressed concerns that unobservable inputs may include entity-specific factors that market participants would not consider. Therefore, they suggested that the IASB should use a different label for measurements that use significant unobservable inputs. However, the IASB concluded that it would be more helpful to users of financial statements to use the label *fair value* for all three levels of the hierarchy described in the exposure draft, for the following reasons:

- (a) The proposed definition of fair value identifies a clear objective for valuation techniques and the inputs to them: consider all factors that market participants would consider and exclude all factors that market participants would exclude. An alternative label for Level 3 measurements would be unlikely to identify such a clear objective.
- (b) The distinction between Levels 2 and 3 is inevitably subjective. It is undesirable to adopt different measurement objectives on either side of such a subjective boundary.

Rather than requiring a different label for measurements derived using significant unobservable inputs, the IASB concluded that concerns about the subjectivity of those measurements are best addressed by requiring enhanced disclosure for those

measurements (see paragraphs BC187–BC210).

- BC174 The IASB accepts that the starting point for Level 3 inputs might be estimates developed by the entity. However, the entity must adjust those inputs if reasonably available information indicates that other market participants would use different data when pricing the asset or liability or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy).
- BC175 Some respondents expressed concerns that an entity would be compelled by its auditors or regulators to undertake exhaustive efforts to obtain information about the assumptions that market participants would use when pricing the asset or liability. Furthermore, they were concerned that their judgement would be questioned when asserting the absence of contrary data. IFRS 13 states that such exhaustive efforts would not be necessary. However, when information about market participant assumptions is reasonably available, an entity cannot ignore it.

Measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased

- BC176 The global financial crisis that started in 2007 emphasised the importance of having common fair value measurement requirements in IFRSs and US GAAP, particularly for measuring fair value when the market activity for an asset or a liability declines. As a result, and consistently with the recommendations of the Group of Twenty (G20) Leaders, the Financial Stability Board and the IASB's and FASB's Financial Crisis Advisory Group, the IASB and the FASB worked together to develop common requirements for measuring the fair value of assets and liabilities when markets are no longer active.
- BC177 In May 2008 the IASB set up a Fair Value Expert Advisory Panel in response to recommendations made by the Financial Stability Forum (now the Financial Stability Board) to address the measurement and disclosure of financial instruments when markets are no longer active. The Panel's discussions were observed by FASB staff. In October 2008 the IASB staff published a staff report on the Panel's discussions.
- BC178 Also in response to the global financial crisis, in April 2009 the FASB issued FASB Staff Position (FSP) No. FAS 157-4 *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. That FSP was codified in Topic 820 and provides guidance for:
- (a) measuring fair value when the volume or level of activity for the asset or liability has significantly decreased; and
 - (b) identifying circumstances that indicate a transaction is not orderly.

- BC179 IASB published a Request for Views that asked respondents whether they believed that the guidance in that FSP was consistent with the Panel's report. The IASB also asked members of the Fair Value Expert Advisory Panel the same question. The IASB received 69 responses to the Request for Views. The respondents to the Request for Views and the members of the Fair Value Expert Advisory Panel indicated that the FSP was consistent with the Panel's report. As a result, the IASB included the guidance from FSP FAS 157-4 in the exposure draft.
- BC180 Respondents to the exposure draft generally agreed with the proposed guidance and found it consistent with the concepts in the IASB's Fair Value Expert Advisory Panel's report and in US GAAP. However, some respondents noted that the words used in the exposure draft were different from those used in US GAAP and wondered whether the requirements were meant to be different. The boards acknowledged those concerns and decided to align the wording. In addition, the boards decided to clarify that the requirements pertain to when there has been a significant decline in the volume or level of activity for the asset or liability, not to assets and liabilities for which there is typically no observable market.
- BC181 Furthermore, the boards concluded that when applying IFRS 13 and Topic 820 an entity should focus on whether an observed transaction price is the result of an orderly transaction, not only on the level of activity in a market, because even in a market with little activity, transactions can be orderly. Accordingly, the boards concluded that an entity should consider observable transaction prices unless there is evidence that the transaction is not orderly. If an entity does not have sufficient information to determine whether a transaction is orderly, it performs further analysis to measure fair value.
- BC182 Also as a result of the global financial crisis, there was a particularly urgent need to improve transparency of fair value measurements for financial instruments. To address that need, the IASB amended IFRS 7 *Financial Instruments: Disclosures* in March 2009. The amended disclosures about fair value measurements have been relocated to IFRS 13.

Disclosure

- BC183 The disclosures about fair value measurements in IFRSs vary, although many require, at a minimum, information about the methods and significant assumptions used in the measurement, and whether fair value was measured using observable prices from recent market transactions for the same or a similar asset or liability.
- BC184 The IASB decided that having established a framework for measuring fair value, it should also enhance and harmonise the disclosures about fair value measurements. The IASB decided to limit the disclosures to fair values measured in the statement of financial position after initial recognition, whether those measurements are made on a recurring or non-recurring basis, because other IFRSs address the disclosure of fair values at initial recognition (eg IFRS 3 requires disclosure of the measurement of assets acquired and liabilities assumed in a business combination).
- BC185 The objective of the disclosures in IFRS 13 is to provide users of financial statements with information about the valuation techniques and inputs used to develop fair value measurements and how fair value measurements using significant unobservable inputs affected profit or loss or other comprehensive income for the period. To meet those objectives, the disclosure framework (a) combines the disclosures currently required by IFRSs and US GAAP and (b) provides additional disclosures that users of financial statements suggested would be helpful in their analyses. In developing the disclosures, the IASB used information received from users and preparers of financial statements and the IASB's Fair Value Expert Advisory Panel.

Distinguishing between recurring and non-recurring fair value measurements

- BC186 The disclosures in US GAAP differentiate fair value measurements that are recurring from those that are non-recurring. The exposure draft did not propose differentiating recurring from non-recurring fair value measurements and required the same information about all fair value measurements. However, users of financial statements asked the IASB to include the same principles for disclosing information about fair value measurements in IFRSs that are in US GAAP. As a result, the boards decided to differentiate the two types of fair value measurements and to describe their differences.

Information about fair value measurements categorised within Level 3 of the fair value hierarchy

- BC187 The boards received requests from users of financial statements for more information about fair value measurements categorised within Level 3 of the fair value hierarchy. The following sections describe the boards' response to those requests.

Quantitative information

- BC188 The exposure draft proposed requiring an entity to disclose the methods and inputs used in a fair value measurement, including the information used to develop those inputs. That proposal was developed using feedback from users of financial statements and the IASB's Fair Value Expert Advisory Panel. Although the proposal was not explicit, the IASB intended that the information about the inputs used in the measurement would be quantitative.
- BC189 Before the amendments to Topic 820, US GAAP required an entity to provide a description of the inputs used when measuring the fair value of an asset or a liability that is categorised within Level 2 or Level 3 of the fair value hierarchy. Topic 820 was not explicit about whether that description needed to include quantitative information.
- BC190 Users of financial statements asked the boards to clarify that entities must provide quantitative information about the inputs used in a fair value measurement, particularly information about unobservable inputs used in a measurement categorised within Level 3 of the fair value hierarchy. When limited or no information is publicly available, disclosures about such information help users to understand the measurement uncertainty inherent in the fair value measurement.
- BC191 Therefore, the boards decided to clarify that an entity should disclose *quantitative* information about the significant unobservable inputs used in a fair value measurement categorised within Level 3 of the fair value hierarchy.
- BC192 Some respondents to the FASB's proposed ASU questioned the usefulness of quantitative information about the unobservable inputs used in a fair value measurement because of the level of aggregation required in those disclosures. The boards noted that the objective of the disclosure is not to enable users of financial statements to replicate the entity's pricing models, but to provide enough information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. The boards concluded that the information required by the disclosure will facilitate comparison of the inputs used over time, providing users with information about changes in management's views about particular unobservable inputs and about changes in the market for the assets and liabilities within a particular class. In addition, that disclosure might facilitate comparison between entities with similar assets and liabilities categorised within Level 3 of the fair value hierarchy.
- BC193 IFRS 13 and Topic 820 state that an entity should determine appropriate classes of assets and liabilities on the basis of the nature, characteristics and risks of the assets

and liabilities, noting that further disaggregation might be required for fair value measurements categorised within Level 3 of the fair value hierarchy. Consequently, the boards concluded that the meaningfulness of the disclosure of quantitative information used in Level 3 fair value measurements will depend on an entity's determination of its asset and liability classes.

- BC194 Some respondents to the IASB's re-exposure document and the FASB's proposed ASU suggested requiring quantitative information about the unobservable inputs used in fair value measurements categorised within Level 2 of the fair value hierarchy because determining whether to categorise fair value measurements within Level 2 or Level 3 can be subjective. The boards concluded that for a fair value measurement to be categorised within Level 2 of the fair value hierarchy, the unobservable inputs used, if any, must not be significant to the measurement in its entirety. As a result, the boards decided that quantitative information about unobservable inputs would be of limited use for those measurements.
- BC195 In addition, the boards understand that fair value is sometimes measured on the basis of prices in prior transactions (eg adjustments to the last round of financing for a venture capital investment) or third-party pricing information (eg broker quotes). Such measurements might be categorised within Level 3 of the fair value hierarchy. In such cases, the boards concluded that an entity should be required to disclose how it has measured the fair value of the asset or liability, but that it should not need to create quantitative information (eg an implied market multiple or future cash flows) to comply with the disclosure requirement if quantitative information other than the prior transaction price or third-party pricing information is not used when measuring fair value. However, the boards concluded that when using a prior transaction price or third-party pricing information, an entity cannot ignore other quantitative information that is reasonably available. If there was an adjustment to the price in a prior transaction or third-party pricing information that is significant to the fair value measurement in its entirety, that adjustment would be an unobservable input about which the entity would disclose quantitative information even if the entity does not disclose the unobservable information used when pricing the prior transaction or developing the third-party pricing information.

Level 3 reconciliation for recurring fair value measurements

- BC196 The exposure draft proposed requiring an entity to provide a reconciliation from the opening balances to the closing balances of fair value measurements categorised within Level 3 of the fair value hierarchy. IFRS 7 required such a disclosure for financial instruments after it was amended in March 2009 to introduce a three-level fair value hierarchy, and to require more detailed information about fair value measurements categorised within Level 3 of the fair value hierarchy. In addition, many IFRSs already required a similar reconciliation for all fair value measurements, not only for those that are categorised within Level 3 of the fair value hierarchy.

- BC197 Some respondents agreed with the proposed reconciliation disclosure because they thought it would help meet the objective to provide meaningful information to users of financial statements about the relative subjectivity of fair value measurements. Other respondents thought that the disclosure requirement would be onerous and did not believe that the benefits would outweigh the costs, particularly for non-financial assets and liabilities. The IASB received similar feedback on the proposed amendments to IFRS 7. However, users of financial statements told the IASB that the disclosures made in accordance with US GAAP and IFRS 7 were helpful, particularly in the light of the global financial crisis that started in 2007. They indicated that the disclosures allowed them to make more informed judgements and to segregate the effects of fair value measurements that are inherently subjective, thereby enhancing their ability to assess the quality of an entity's reported earnings. Consequently, the IASB decided to require an entity to provide such a reconciliation.
- BC198 The exposure draft and IFRS 7 did not distinguish between *realised* and *unrealised* gains or losses. That was because those documents referred to *gains or losses attributable to assets and liabilities held at the end of the reporting period*, which the IASB meant to be equivalent to *unrealised* gains or losses (ie realised gains or losses result from the sale, disposal or settlement of an asset or a liability, and therefore the asset or liability is no longer held by the entity at the reporting date, whereas unrealised gains or losses relate to changes in the fair value of an asset or a liability that is held by the entity at the reporting date). Respondents to the exposure draft wondered whether the different terminology used in the exposure draft and in Topic 820 meant that the disclosure proposed for IFRSs would be different from the disclosure required by US GAAP. To ensure that there would be no differences in interpretation of the requirements in IFRSs and US GAAP, the IASB decided to use the terms *realised* and *unrealised* in the reconciliation disclosure.
- BC199 The IASB concluded that the disclosure should focus on recurring fair value measurements because it would be difficult to reconcile the opening balances to the closing balances for non-recurring fair value measurements when the carrying amount of an asset or a liability is not determined on the basis of fair value at each reporting period. For example, it would be difficult to reconcile changes in fair value when an asset held for sale is recognised at its carrying amount in accordance with IFRS 5 in one period and at fair value less costs to sell in the next period. The information gained from requiring a reconciliation of changes in fair value from one period to the next is not available when requiring changes resulting from the use of different measurement bases from one period to the next.

Valuation processes

- BC200 The boards decided to require an entity to disclose the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). They made that decision because users of financial statements told the boards that information about an entity's valuation processes helps them assess the relative subjectivity of the entity's fair value measurements, particularly for those categorised within Level 3 of the fair value hierarchy.
- BC201 In addition, the requirements in IFRS 13 are consistent with the conclusions of the IASB's Fair Value Expert Advisory Panel as described in its report in October 2008.

Sensitivity to changes in unobservable inputs

- BC202 The exposure draft proposed requiring a quantitative sensitivity analysis for fair value measurements categorised within Level 3 of the fair value hierarchy. That proposal was taken from the requirement in IFRS 7 to disclose a sensitivity analysis if changing any of the unobservable inputs used in the measurement to reasonably possible alternative assumptions would change the fair value significantly. Although in IFRS 7

that disclosure was required for financial assets and financial liabilities measured at fair value, under the proposal it would have been required for all assets and liabilities measured at fair value.

- BC203 In August 2009 the FASB proposed a similar disclosure requirement in its proposed ASU *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, although that proposal would have required an entity to take into account the effect of interrelationships between inputs. Very few respondents to that proposed ASU supported the proposed disclosure, stating that it would not provide useful information and would be costly and operationally challenging. However, users were supportive of the proposed disclosure. The FASB decided to defer the consideration of a sensitivity analysis disclosure requirement to the joint fair value measurement project.
- BC204 In the boards' discussions about that sensitivity analysis disclosure, they considered whether the IASB's proposed disclosure and that in IFRS 7 would be improved if the boards required an entity to include the effect of interrelationships between unobservable inputs, thereby showing a range of fair values (exit prices) that reasonably could have been measured in the circumstances as of the measurement date. Because that refinement of the disclosure was not included in the IASB's May 2009 exposure draft and was not required by IFRS 7, the IASB needed to expose the proposal to require the sensitivity analysis including the effect of interrelationships between unobservable inputs. That disclosure was referred to in the IASB's re-exposure document and the FASB's proposed ASU in June 2010 as a *measurement uncertainty analysis disclosure*.
- BC205 Respondents to the FASB's proposed ASU and the IASB's re-exposure document were concerned about whether the proposal would be operational (those comments were consistent with those received on the FASB's proposed ASU in August 2009). Although that proposal was in response to requests from users of financial statements to require additional information about the measurement uncertainty inherent in fair value measurements (particularly those categorised within Level 3 of the fair value hierarchy), the responses from preparers of financial statements indicated that the costs associated with preparing such a disclosure would outweigh the benefits to users once the information had been aggregated by class of asset or liability. As an alternative to the proposal, those respondents suggested that the boards should require a qualitative assessment of the subjectivity of fair value measurements categorised within Level 3 of the fair value hierarchy, as well as an alternative quantitative approach that would be less costly to prepare (see paragraphs BC188–BC195).
- BC206 Therefore, the boards decided to require an entity to provide a narrative description, by class of asset or liability, of the sensitivity of a recurring fair value measurement categorised within Level 3 of the fair value hierarchy to changes in the unobservable inputs used in the measurement if a change in those inputs to a different amount would result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs, the boards decided to require an entity to provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. The boards concluded that such information would provide users of financial statements with information about how the selection of unobservable inputs affects the valuation of a particular class of assets or liabilities. The boards expect that the narrative description will focus on the unobservable inputs for which quantitative information is disclosed because those are the unobservable inputs that the entity has determined are most significant to the fair value measurement. They will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical after issuing IFRS 13, with the aim of reaching a conclusion about whether to require such a disclosure at a later date.

- BC207 The boards concluded that a narrative description about sensitivity provides users of financial statements with information about the directional effect of a change in a significant unobservable input on a fair value measurement. That disclosure, coupled with quantitative information about the inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy, provides information for users to assess whether the entity's views about individual inputs differed from their own and, if so, to decide how to incorporate the entity's fair value measurement in their decisions. In addition, that disclosure provides information about the pricing model for those users who are not familiar with the valuation of a particular class of assets or liabilities (eg complex financial instruments).
- BC208 In addition to the narrative sensitivity analysis disclosure, IFRS 13 requires a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (ie the disclosure that was previously in IFRS 7). The IASB decided to move that requirement from IFRS 7 to IFRS 13 so that all the fair value measurement disclosure requirements in IFRSs are in a single location. When developing IFRS 7, the IASB concluded that information about the sensitivities of fair value measurements to the main valuation assumptions would provide users of financial statements with a sense of the potential variability of the measurement. In forming that conclusion, the IASB considered the view that disclosure of sensitivities could be difficult, particularly when there are many assumptions to which the disclosure would apply and those assumptions are interdependent. However, the IASB noted that a detailed quantitative disclosure of sensitivity to all assumptions is not required (only those that could result in a significantly different estimate of fair value are required) and that the disclosure does not require the entity to reflect interdependencies between assumptions when making the disclosure.
- BC209 The boards concluded that the objective of the narrative and quantitative sensitivity analysis disclosures about fair value are different from the objectives of other disclosures that an entity may be required to make in IFRSs and US GAAP, such as the market risk sensitivity analysis disclosure required by IFRS 7 (see paragraph 40 of IFRS 7). The IASB concluded that even though there is some overlap in those disclosures, the objective of each disclosure is different: the market risk sensitivity analysis disclosure in IFRS 7 provides information about an entity's exposure to future changes in market risks (ie currency risk, interest rate risk and other price risk), whereas the fair value measurement disclosures provide information about the sensitivity of the fair value measurement at the measurement date to changes in unobservable inputs for those fair value measurements with the greatest level of subjectivity (ie fair value measurements categorised within Level 3 of the fair value hierarchy). In addition, the market risk sensitivity analysis disclosure in IFRS 7 relates only to financial instruments (as does the quantitative sensitivity analysis disclosure in IFRS 13), whereas the narrative sensitivity analysis disclosure in IFRS 13 relates to all assets and liabilities measured at fair value.

BC210 The IASB identified the following differences between the market risk and fair value sensitivity analysis disclosures:

- (a) The market risk disclosure is not specific to financial instruments measured at fair value, but also relates to financial instruments measured at amortised cost.
- (b) The market risk disclosure focuses on the effect on profit or loss and equity, not specifically on the change in value.
- (c) The market risk disclosure focuses only on the entity's exposure to market risks (ie interest rate risk, currency risk or other price risk), whereas the fair value disclosures take into account the effect on a fair value measurement of changes in significant unobservable inputs.
- (d) The market risk disclosure does not distinguish between observable and unobservable inputs (or level in the fair value hierarchy, ie Level 1, 2 or 3), whereas the fair value disclosures relate only to the unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy.

Transfers between Levels 1 and 2 of the fair value hierarchy

BC211 The exposure draft proposed requiring an entity to disclose the amounts of *significant* transfers into or out of Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. That disclosure was also required in Topic 820. In their discussions, the boards decided instead to require a disclosure of *any* transfers into or out of Levels 1 and 2. Respondents to the FASB's proposed ASU generally did not support that proposal because it would require an entity to monitor all transfers on a daily basis, regardless of whether those transfers were significant. In addition, respondents were concerned about the accuracy of information about all transfers because there can be an unclear distinction between less active Level 1 fair value measurements and more active Level 2 fair value measurements.

BC212 The boards concluded that the objective of the disclosure is to provide information that will help users of financial statements assess changes in market and trading activity (the entity's or others') so that users can (a) incorporate into their analyses the entity's future liquidity risk and (b) analyse the entity's exposure to the relative subjectivity of its fair value measurements. In the boards' view, the only way to provide that information, and to reduce the subjectivity involved in preparing the information, is to require information about *all* transfers between Level 1 and Level 2 of the fair value hierarchy.

When an entity uses a non-financial asset in a way that differs from its highest and best use

BC213 The boards decided to require an entity to disclose information about when it uses a non-financial asset in a way that differs from its highest and best use (when that asset is measured at fair value in the statement of financial position or when its fair value is disclosed). The boards concluded that such a disclosure provides useful information for users of financial statements that rely on fair value information when forecasting future cash flows, whether that fair value information is presented in the statement of financial position or is disclosed in the notes. Users told the boards that they would need to know how non-financial assets are being used and how that use fits with an entity's strategic and operating plans.

BC214 The boards considered whether to limit the disclosure to some non-financial assets and not others. The boards concluded that because the measurement and disclosure requirements are principle-based, those requirements should not need to be amended in the future if the boards should decide to use fair value as the measurement basis for particular assets or liabilities. Therefore, the disclosure is required for any

non-financial asset measured at fair value that an entity uses in a way that differs from its highest and best use.

The categorisation within the level of the fair value hierarchy for items that are not measured at fair value in the statement of financial position

- BC215 IFRS 7 requires an entity to disclose the fair value of financial instruments even if they are not measured at fair value in the statement of financial position. An example is a financial instrument that is measured at amortised cost in the statement of financial position.
- BC216 The boards decided to require an entity to disclose the level of the fair value hierarchy in which an asset or a liability (financial or non-financial) would be categorised if that asset or liability had been measured at fair value in the statement of financial position. The boards concluded that such a disclosure would provide meaningful information about the relative subjectivity of that fair value measurement.
- BC217 Respondents to the IASB's exposure draft and the FASB's proposed ASU were concerned about the cost associated with preparing that disclosure because it is not always clear in which level a fair value measurement would be categorised. The boards concluded that even if determining the level in which to categorise a fair value measurement requires judgement, the benefits of doing so outweigh the costs. Therefore, the boards decided to require an entity to disclose the level of the fair value hierarchy in which an asset or a liability would be categorised if that asset or liability had been measured at fair value in the statement of financial position.

Assets with a recoverable amount that is fair value less costs of disposal

- BC218 Because IAS 36 requires disclosures that are specific to impaired assets, the exposure draft did not propose requiring the disclosures about fair value measurements for assets with a recoverable amount that is fair value less costs of disposal in IAS 36. Some respondents (mainly users of financial statements) noted that the disclosures about impaired assets are different in IFRSs and in US GAAP (which requires assets to be tested for impairment by comparing their carrying amounts with their fair values) and asked the IASB to minimise those differences to ensure that users have access to similar information for their analyses of impaired assets.
- BC219 The IASB noted that the disclosure requirements in IAS 36 were developed specifically to ensure consistency in the disclosure of information about impaired assets so that the same type of information is provided whether the recoverable amount was determined on the basis of value in use or fair value less costs of disposal. Consequently, the IASB did not think it would be appropriate to require an entity to provide information when the recoverable amount is determined on the basis of fair value less costs of disposal (ie as required by IFRS 13) that is significantly different from what the entity would provide when the recoverable amount is determined on the basis of value in use.
- BC220 Although IFRSs and US GAAP have different impairment models, the IASB concluded that requiring the following information (in addition to what IAS 36 currently requires) about impaired assets measured at fair value less costs of disposal would improve comparability between entities applying IFRSs and those applying US GAAP as well as increase the convergence of IFRSs and US GAAP:
- (a) the fair value less costs of disposal;
 - (b) the level of the fair value hierarchy within which the fair value less costs of disposal is categorised in its entirety (Level 1, 2 or 3);

- (c) if applicable, changes to valuation techniques and reasons for those changes; and
- (d) quantitative information about significant inputs used when measuring fair value less costs of disposal (along with a conforming amendment to the disclosures about value in use).

BC221 In addition, those disclosures are consistent with the disclosures required for non-recurring fair value measurements in IFRS 13 and in US GAAP.

Interim financial reporting

BC222 For financial instruments, the exposure draft proposed that particular fair value disclosures required in annual financial statements would also be required for interim financial reports. That differed from the approach proposed for non-financial assets and non-financial liabilities, for which there is no specific fair value disclosure requirement beyond the existing requirements in IAS 34 *Interim Financial Reporting*.

BC223 Respondents generally thought that the principle underlying IAS 34 addresses when disclosures should be updated in interim financial reports. Some respondents thought the costs of providing updated information outweighed the benefits to users of financial statements of having that information.

BC224 The IASB decided to include in IAS 34 an explicit requirement to provide updated disclosures because it concluded that the benefit of having incremental disclosures for financial instruments outweighed the associated costs given the increased interest in those instruments during the global financial crisis that started in 2007.

Effective date and transition

BC225 When deciding the effective date for IFRS 13, the IASB considered the comments received on the Request for Views *Effective Date and Transition Methods*. Many respondents said that the effective date should allow enough time for them to put the necessary systems in place to ensure that their accounting policies and models meet the requirements of IFRS 13. Some of those respondents, particularly those with many assets and liabilities measured at fair value, requested a later effective date. Other respondents requested an earlier effective date, mainly for comparability reasons and because in their view many entities might have inadvertently already started applying the revised concepts.

- BC226 The IASB concluded that although IFRS 13 is a major new standard, it does not require any new fair value measurements and it does not fundamentally change many of the requirements for measuring fair value or for disclosing information about those measurements. The IASB concluded that in many respects, IFRS 13 uses different words to articulate the concepts already present in IFRSs. However, the IASB also considered the time that a particular country might require for translation and for introducing the mandatory requirements into law.
- BC227 Consequently, the IASB decided that IFRS 13 should be effective for annual periods beginning on or after 1 January 2013. Because IFRS 13 applies when other IFRSs require or permit fair value measurements (and does not introduce any new fair value measurements), the IASB believes that the extended transition period for IFRS 13 provides enough time for entities, their auditors and users of financial statements to prepare for implementation of its requirements.
- BC228 The IASB decided to permit early application of IFRS 13 because that would allow entities to apply the measurement and disclosure requirements as soon as practicable, thereby improving comparability in measurement and transparency in disclosures. That would also improve comparability with entities applying US GAAP.
- BC229 The exposure draft proposed prospective application because the IASB concluded that a change in the methods used to measure fair value would be inseparable from a change in the fair value measurements (ie as new events occur or as new information is obtained, eg through better insight or improved judgement). Respondents to the exposure draft and the Request for Views supported that proposal. Therefore, the IASB concluded that IFRS 13 should be applied prospectively (in the same way as a change in accounting estimate).
- BC230 To achieve comparability in future periods, the IASB decided to require the disclosures in IFRS 13 for the first interim period in which the IFRS is initially applied. However, those disclosures need not be presented in periods before initial application of the IFRS because it would be difficult to apply some of the requirements in IFRS 13 without the use of hindsight in selecting the inputs that would have been appropriate in prior periods.
- BC230A *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 52 and added paragraph C4 to clarify the scope of the portfolio exception. It considered the transition provisions and effective date of the amendments to IFRS 13. It decided that an entity should apply that amendment for annual periods beginning on or after 1 July 2014. In order to be consistent with the prospective initial application of IFRS 13, the IASB decided that an entity would apply the amendment to IFRS 13 prospectively from the beginning of the annual period in which IFRS 13 was initially applied.

Application in emerging and transition economies

BC231 During the development of IFRS 13, the IASB received information from entities in emerging and transition economies that had concerns about applying the fair value measurement principles in IFRS 13 in their jurisdictions. Common concerns included the following:

- (a) The fair value measurement guidance is not detailed enough to allow them to measure fair value on a consistent basis.
- (b) There is limited availability of practitioners in their jurisdictions who have the skills to apply the guidance (and as a result entities might be unfamiliar with applying the necessary judgements).
- (c) There is limited access to market data to develop fair value measurements because there are few deep and liquid markets, there are often few willing buyers and sellers and prices often fluctuate considerably within short periods of time.

- (d) Models, inputs and assumptions may be new and may not be comparable across entities because of rapidly developing socio-economic changes.
- (e) Measuring fair value (and preparing the resulting disclosures) could be expensive.

BC232 The IASB noted that because fair value is used in many IFRSs, knowledge about its application is necessary for applying IFRSs generally and noted that the concerns raised are not specific to entities in emerging and transition economies. Entities in developed economies faced similar challenges during the global financial crisis that started in 2007 and asked the IASB for guidance for measuring the fair value of equity instruments without active markets given the requirement to recognise them at fair value in IFRS 9. Furthermore, the IASB concluded that there should not be a different threshold for measuring fair value depending on jurisdiction. Only by performing fair value measurements will entities applying IFRSs learn how to do those measurements appropriately and robustly.

BC233 Therefore, the IASB concluded that entities applying IFRSs would benefit from educational material to accompany IFRS 13. The IFRS Foundation sometimes publishes educational material that is leveraged from the standard-setting process to reinforce the goal of promoting the adoption and consistent application of a single set of high quality international accounting standards. The IASB asked the staff to develop educational material on fair value measurement that describes at a high level the thought process for measuring assets, liabilities and an entity's own equity instruments at fair value consistent with the objective of a fair value measurement.

BC234 The IASB concluded that any educational material developed must benefit all entities equally. Thus, the educational material cannot benefit entities in emerging and transition economies without being made available to entities in developed economies.

BC235 The IASB staff and the FASB staff will liaise during the development of the educational material.

Convergence with US GAAP

BC236 As noted above, the fair value measurement project was a joint project with the FASB. The boards worked together to ensure that fair value has the same meaning in IFRSs and in US GAAP and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style).

BC237 The boards worked together to ensure that, to the extent possible, IFRS 13 and Topic 820 are identical. The following style differences remain:

- (a) There are differences in references to other IFRSs and US GAAP—For example, regarding related party transactions, IFRS 13 refers to IAS 24 *Related Party Disclosures* and Topic 820 refers to Topic 850 *Related Party Disclosures*.
- (b) There are differences in style—For example, IFRS 13 refers to *an entity* and Topic 820 refers to *a reporting entity*.

- (c) There are differences in spelling—For example, IFRS 13 refers to *labour costs* and Topic 820 refers to *labor costs*.
- (d) There are differences in whether references are to a particular jurisdiction or are generic—For example, IFRS 13 refers to *risk-free government securities* and Topic 820 refers to *US Treasury securities*.

The boards concluded that those differences will not result in inconsistent interpretations in practice by entities applying IFRSs or US GAAP.

BC238 In addition, IFRS 13 and Topic 820 have the following differences:

- (a) There are different accounting requirements in IFRSs and US GAAP for measuring the fair value of investments in investment companies. Topic 946 *Financial Services—Investment Companies* in US GAAP requires an investment company to recognise its underlying investments at fair value at each reporting period. Topic 820 provides a practical expedient that permits an entity with an investment in an investment company to use as a measure of fair value in specific circumstances the reported net asset value without adjustment. IFRS 10 *Consolidated Financial Statements* requires an investment company to consolidate its controlled underlying investments. Because IFRSs do not have accounting requirements that are specific to investment companies, the IASB decided that it would be difficult to identify when such a practical expedient could be applied given the different practices for calculating net asset values in jurisdictions around the world. For example, investment companies may report in accordance with national GAAP, which may have recognition and measurement requirements that differ from those in IFRSs (ie the underlying investments might not be measured at fair value, or they might be measured at fair value in accordance with national GAAP, not IFRSs). The boards are reviewing the accounting for investment companies as part of a separate project.*
- (b) There are different requirements for measuring the fair value of a financial liability with a demand feature. In US GAAP, Topic 825 *Financial Instruments* and Topic 942 *Financial Services—Depository and Lending* describe the fair value measurement of a deposit liability as the amount payable on demand at the reporting date. In IFRSs, IFRS 13 states that the fair value measurement of a financial liability with a demand feature (eg demand deposits) cannot be less than the present value of the amount payable on demand. That requirement in IFRS 13 was relocated unchanged from IAS 39 and IFRS 9 as a consequence of the IASB's fair value measurement project.
- (c) There are different disclosure requirements in IFRSs and US GAAP. For example:
 - (i) Because IFRSs generally do not allow net presentation for derivatives, the amounts disclosed for fair value measurements categorised within Level 3 of the fair value hierarchy might differ. The boards are reviewing the presentation requirements for offsetting financial assets and financial liabilities in their joint project on the accounting for financial instruments.

* In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which required investment entities, as defined in IFRS 10 *Consolidated Financial Statements*, to measure their investments in subsidiaries, other than those providing investment-related services or activities, at fair value through profit or loss. In their redeliberations on the Investment Entities project, the Board considered providing a net asset value practical expedient. However, the Board decided against this because there are different calculation methods in different jurisdictions and it is outside the scope of the Investment Entities project to provide fair value measurement guidance for investments in investment entities.

- (ii) IFRSs require a quantitative sensitivity analysis for financial instruments that are measured at fair value and categorised within Level 3 of the fair value hierarchy (that disclosure was previously in IFRS 7). The boards will analyse the feasibility of incorporating information about interrelationships between unobservable inputs into a quantitative measurement uncertainty analysis disclosure. After completing that analysis, the boards will decide whether to require such a disclosure.
- (iii) Topic 820 has different disclosure requirements for non-public entities. The FASB concluded that some of the disclosures should not be required for non-public entities because of the characteristics of the users of the financial statements of those entities. The FASB considered the ability of those users to access information about the financial position of the entity and the relevance to those users of the information that would be provided by the requirements in the disclosure amendments. In contrast, the IASB recently completed a project on the accounting for small and medium-sized entities. As a result, the *IFRS for Small and Medium-Sized Entities* addresses the accounting for entities that do not have public accountability, and the disclosures about their fair value measurements.

Cost-benefit considerations

- BC239 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. To meet that objective, the IASB seeks to ensure that an IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new standard might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.
- BC240 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the IASB considers the following:
- (a) the costs incurred by preparers of financial statements;
 - (b) the costs incurred by users of financial statements when information is not available;
 - (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and
 - (d) the benefit of better economic decision-making as a result of improved financial reporting.
- BC241 IFRS 13 defines fair value, provides a framework for measuring fair value and requires disclosures about fair value measurements. A clear definition of fair value, together with a framework for measuring fair value that eliminates inconsistencies across IFRSs that have contributed to diversity in practice, should improve consistency in application, thereby enhancing the comparability of information reported in financial statements.
- BC242 The disclosures about fair value measurements would increase transparency and improve the quality of information provided to users of financial statements. In developing the disclosure requirements in IFRS 13, the IASB obtained input from users and preparers of financial statements and other interested parties to enable the IASB to assess whether the disclosures could be provided within reasonable cost-benefit constraints.

BC243 Although the framework for measuring fair value builds on current practice and requirements, some methods in IFRS 13 may result in a change to practice for some entities. Furthermore, some entities will need to make systems and operational changes, thereby incurring incremental costs. Other entities also might incur incremental costs in applying the measurement and disclosure requirements. However, the IASB concluded that the benefits resulting from increased consistency in application of fair value measurement requirements and enhanced comparability of fair value information and improved communication of that information to users of financial statements will continue. On balance, the IASB concluded that improvements in financial reporting resulting from the application of the requirements in IFRS 13 will exceed the increased costs of applying the requirements.

Summary of main changes from the exposure draft

BC244 The main changes from the proposals in the exposure draft published in May 2009 are as follows:

- (a) IFRS 13 excludes from its scope share-based payment transactions in IFRS 2 and leasing transactions in IAS 17. The exposure draft proposed the following:
 - (i) replacing the term *fair value* with another term that reflects the measurement objective for share-based payment transactions in IFRS 2 and for reacquired rights in a business combination in IFRS 3.
 - (ii) excluding financial liabilities with a demand feature in IAS 39* from the scope of an IFRS on fair value measurement.

The exposure draft did not propose excluding leasing transactions from the scope of an IFRS on fair value measurement.

- (b) IFRS 13 requires fair value to be measured using the price in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The exposure draft proposed that fair value should be measured using the price in the most advantageous market.
- (c) IFRS 13 states that market participants have a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary. The exposure draft stated that market participants are presumed to be as knowledgeable as the entity about the asset or liability (ie there was no information asymmetry between market participants and the entity).
- (d) IFRS 13 contains detailed guidance for measuring the fair value of liabilities, including the compensation market participants would require to assume the liability and how a third-party credit enhancement affects the fair value of a liability. The exposure draft provided high level guidance.
- (e) IFRS 13 contains detailed guidance for measuring the fair value of an entity's own equity instruments. That guidance is consistent with the guidance for measuring the fair value of a liability. The exposure draft proposed requiring an entity to measure the fair value of its own equity instruments by reference to the fair value of the instrument held by a market participant as an asset (ie the corresponding asset) without providing information about when the fair value of the equity instrument might differ from the fair value of the corresponding asset.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (f) IFRS 13 provides guidance for measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk. The exposure draft proposed requiring financial assets to be measured using an in-exchange valuation premise.
- (g) IFRS 13 states that classes of asset or liability for disclosure purposes should be determined on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy within which the fair value measurement is categorised. The exposure draft did not provide guidance for determining the appropriate class of asset or liability for disclosures about fair value measurements.
- (h) IFRS 13 provides examples of policies for when to recognise transfers between levels of the fair value hierarchy, such as the date of the transfer, the beginning of the reporting period or the end of the reporting period. IFRS 13 also states that the policy about the timing of recognising transfers must be the same for transfers into a level as that for transfers out of a level. The exposure draft did not provide guidance for determining when transfers are deemed to have occurred or propose to require an entity to disclose its policy for determining when transfers between levels are recognised.
- (i) IFRS 13 requires a narrative discussion of the sensitivity of a fair value measurement categorised within Level 3 of the fair value hierarchy to changes in significant unobservable inputs and any interrelationships between those inputs that might magnify or mitigate the effect on the measurement. It also requires a quantitative sensitivity analysis for financial instruments categorised within Level 3 of the fair value hierarchy (that disclosure was relocated from IFRS 7). The exposure draft proposed a quantitative sensitivity analysis for assets and liabilities categorised within Level 3 of the fair value hierarchy. The IASB re-exposed that proposal, including a requirement to take into account the interrelationships between unobservable inputs in the analysis (referred to as a measurement uncertainty analysis disclosure). Respondents were concerned about whether the proposal would be operational. The boards will continue to assess whether a quantitative measurement uncertainty analysis disclosure would be practical after the IFRS is issued, with the aim of reaching a conclusion about whether to require such a disclosure at a later date.
- (j) IFRS 13 requires an entity to disclose information about its valuation processes (eg valuation policies and procedures) for fair value measurements categorised within Level 3 of the fair value hierarchy. The disclosure is similar to the description of valuation processes in the IASB's Fair Value Expert Advisory Panel's October 2008 report.
- (k) If the highest and best use of a non-financial asset differs from its current use, IFRS 13 requires an entity to disclose that fact and why the asset is being used in a manner that differs from its highest and best use. The exposure draft proposed requiring an entity to disclose the value of the asset assuming its current use, the amount by which the fair value of the asset differs from its fair value in its current use (ie the incremental value of the asset group) and the reasons the asset is being used in a manner that differs from its highest and best use.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 13 and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.

The amendments contained in this appendix when IFRS 13 was issued have been incorporated into the Basis for Conclusions on the relevant IFRSs.

HKFRS 15
Revised June 2016 September 2018

Effective for annual periods
beginning on or after 1 January 2018

Hong Kong Financial Reporting Standard 15

Revenue from Contracts with Customers



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 15 *Revenue from Contracts with Customers* (HKFRS 15) is set out in paragraphs 1–129 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time that they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. The Standard should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Overview

- IN1 Hong Kong Financial Reporting Standard 15 *Revenue from Contracts with Customers* (HKFRS 15) establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers.
- IN2 HKFRS 15 is effective for annual periods beginning on or after 1 January 2018. Earlier application is permitted.
- IN3 HKFRS 15 supersedes:
- (a) HKAS 11 *Construction Contracts*;
 - (b) HKAS 18 *Revenue*;
 - (c) HK(IFRIC)-Int 13 *Customer Loyalty Programmes*;
 - (d) HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate*;
 - (e) HK(IFRIC)-Int 18 *Transfers of Assets from Customers*; and
 - (f) HK(SIC)-Int 31 *Revenue—Barter Transactions Involving Advertising Services*.

Reasons for issuing HKFRS 15

- IN4 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKFRS 15 is to maintain international convergence arising from the issuance of IFRS 15 by the International Accounting Standards Board (IASB).

Revenue is an important number to users of financial statements in assessing an entity's financial performance and position. However, previous revenue recognition requirements in International Financial Reporting Standards (IFRS) differed from those in US Generally Accepted Accounting Principles (US GAAP) and both sets of requirements were in need of improvement. Previous revenue recognition requirements in IFRS provided limited guidance and, consequently, the two main revenue recognition Standards, IAS 18 and IAS 11, could be difficult to apply to complex transactions. In addition, IAS 18 provided limited guidance on many important revenue topics such as accounting for multiple-element arrangements. In contrast, US GAAP comprised broad revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for economically similar transactions.

- IN5 Accordingly, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), initiated a joint project to clarify the principles for recognising revenue and to develop a common revenue standard for IFRS and US GAAP that would:
- (a) remove inconsistencies and weaknesses in previous revenue requirements;
 - (b) provide a more robust framework for addressing revenue issues;
 - (c) improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;
 - (d) provide more useful information to users of financial statements through improved disclosure requirements; and

- (e) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.
- IN6 IFRS 15, together with Topic 606 that was introduced into the FASB *Accounting Standards Codification®* by Accounting Standards Update 2014-09 *Revenue from Contracts with Customers* (Topic 606), completes the joint effort by the IASB and the FASB to meet those objectives and improve financial reporting by creating a common revenue recognition standard for IFRS and US GAAP.

Main features

- IN7 The core principle of HKFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognises revenue in accordance with that core principle by applying the following steps:
- (a) **Step 1: Identify the contract(s) with a customer**—a contract is an agreement between two or more parties that creates enforceable rights and obligations. The requirements of HKFRS 15 apply to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, HKFRS 15 requires an entity to combine contracts and account for them as one contract. HKFRS 15 also provides requirements for the accounting for contract modifications.
 - (b) **Step 2: Identify the performance obligations in the contract**—a contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.
 - (c) **Step 3: Determine the transaction price**—the transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price is also adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
 - (d) **Step 4: Allocate the transaction price to the performance obligations in the contract**—an entity typically allocates the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract. If a stand-alone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.
 - (e) **Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation**—an entity recognises revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognised is the amount allocated to the satisfied performance

obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognises revenue over time by selecting an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligation.

IN8 HKFRS 15 also includes a cohesive set of disclosure requirements that would result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts with customers. Specifically, HKFRS 15 requires an entity to provide information about:

- (a) revenue recognised from contracts with customers, including the disaggregation of revenue into appropriate categories;
- (b) contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities;
- (c) performance obligations, including when the entity typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract;
- (d) significant judgements, and changes in judgements, made in applying the requirements to those contracts; and
- (e) assets recognised from the costs to obtain or fulfil a contract with a customer.

IN9 The IASB and the FASB achieved their goal of reaching the same conclusions on all requirements for the accounting for revenue from contracts with customers. As a result, IFRS 15 and Topic 606 are substantially the same. However, there are some minor differences which are outlined in the appendix to the Basis for Conclusions.

Hong Kong Financial Reporting Standard 15

Revenue from Contracts with Customers

Objective

- 1 The objective of this Standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of *revenue* and cash flows arising from a *contract with a customer*.

Meeting the objective

- 2 To meet the objective in paragraph 1, the core principle of this Standard is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
- 3 An entity shall consider the terms of the contract and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances.
- 4 This Standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or *performance obligations*) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

Scope

- 5 An entity shall apply this Standard to all contracts with customers, except the following:
- (a) lease contracts within the scope of HKAS 17 *Leases*;
 - (b) insurance contracts within the scope of HKFRS 4 *Insurance Contracts*;
 - (c) financial instruments and other contractual rights or obligations within the scope of HKFRS 9 *Financial Instruments*, HKFRS 10 *Consolidated Financial Statements*, HKFRS 11 *Joint Arrangements*, HKAS 27 *Separate Financial Statements* and HKAS 28 *Investments in Associates and Joint Ventures*; and
 - (d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.
- 6 An entity shall apply this Standard to a contract (other than a contract listed in paragraph 5) only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.
- 7 A contract with a customer may be partially within the scope of this Standard and partially within the scope of other Standards listed in paragraph 5.

- (a) If the other Standards specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement requirements in those Standards. An entity shall exclude from the *transaction price* the amount of the part (or parts) of the contract that are initially measured in accordance with other Standards and shall apply paragraphs 73–86 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Standard and to any other parts of the contract identified by paragraph 7(b).
 - (b) If the other Standards do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply this Standard to separate and/or initially measure the part (or parts) of the contract.
- 8 This Standard specifies the accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfil a contract with a customer if those costs are not within the scope of another Standard (see paragraphs 91–104). An entity shall apply those paragraphs only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of this Standard.

Recognition

Identifying the contract

- 9 **An entity shall account for a contract with a customer that is within the scope of this Standard only when all of the following criteria are met:**
- (a) **the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;**
 - (b) **the entity can identify each party's rights regarding the goods or services to be transferred;**
 - (c) **the entity can identify the payment terms for the goods or services to be transferred;**
 - (d) **the contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and**
 - (e) **it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 52).**
- 10 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

- 11 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply this Standard to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations.
- 12 For the purpose of applying this Standard, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:
- (a) the entity has not yet transferred any promised goods or services to the customer; and
 - (b) the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.
- 13 If a contract with a customer meets the criteria in paragraph 9 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer.
- 14 If a contract with a customer does not meet the criteria in paragraph 9, an entity shall continue to assess the contract to determine whether the criteria in paragraph 9 are subsequently met.
- 15 When a contract with a customer does not meet the criteria in paragraph 9 and an entity receives consideration from the customer, the entity shall recognise the consideration received as revenue only when either of the following events has occurred:
- (a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or
 - (b) the contract has been terminated and the consideration received from the customer is non-refundable.
- 16 An entity shall recognise the consideration received from a customer as a liability until one of the events in paragraph 15 occurs or until the criteria in paragraph 9 are subsequently met (see paragraph 14). Depending on the facts and circumstances relating to the contract, the liability recognised represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

Combination of contracts

- 17 An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:
- (a) the contracts are negotiated as a package with a single commercial objective;
 - (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
 - (c) the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 22–30.

Contract modifications

- 18 A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply this Standard to the existing contract until the contract modification is approved.
- 19 A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 50–54 on estimating variable consideration and paragraphs 56–58 on constraining estimates of variable consideration.
- 20 An entity shall account for a contract modification as a separate contract if both of the following conditions are present:
- (a) the scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 26–30); and
 - (b) the price of the contract increases by an amount of consideration that reflects the entity's *stand-alone selling prices* of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the stand-alone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.
- 21 If a contract modification is not accounted for as a separate contract in accordance with paragraph 20, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (ie the remaining promised goods or services) in whichever of the following ways is applicable:
- (a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 22(b)) is the sum of:
 - (i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and
 - (ii) the consideration promised as part of the contract modification.
 - (b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the

transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).

- (c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

Identifying performance obligations

- 22 At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:**

- (a) **a good or service (or a bundle of goods or services) that is distinct; or**
- (b) **a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 23).**

- 23** A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- (a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 35 to be a performance obligation satisfied over time; and
- (b) in accordance with paragraphs 39–40, the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Promises in contracts with customers

- 24** A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

- 25** Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

Distinct goods or services

- 26** Depending on the contract, promised goods or services may include, but are not limited to, the following:

- (a) sale of goods produced by an entity (for example, inventory of a manufacturer);
- (b) resale of goods purchased by an entity (for example, merchandise of a retailer);
- (c) resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs B34–B38);

- (d) performing a contractually agreed-upon task (or tasks) for a customer;
 - (e) providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides;
 - (f) providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs B34–B38);
 - (g) granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer);
 - (h) constructing, manufacturing or developing an asset on behalf of a customer;
 - (i) granting licences (see paragraphs B52–B63B); and
 - (j) granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs B39–B43).
- 27 A good or service that is promised to a customer is distinct if both of the following criteria are met:
- (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and
 - (b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract).
- 28 A customer can benefit from a good or service in accordance with paragraph 27(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.
- 29 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 27(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:
- (a) the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer.

A combined output or outputs might include more than one phase, element or unit.

- (b) one or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, one or more of the other goods or services promised in the contract.
 - (c) the goods or services are highly interdependent, or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfil its promise by transferring each of the goods or services independently.
- 30 If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Satisfaction of performance obligations

- 31 **An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.**
- 32 For each performance obligation identified in accordance with paragraphs 22–30, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 35–37) or satisfies the performance obligation at a point in time (in accordance with paragraph 38). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.
- 33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
- (a) using the asset to produce goods or provide services (including public services);
 - (b) using the asset to enhance the value of other assets;
 - (c) using the asset to settle liabilities or reduce expenses;
 - (d) selling or exchanging the asset;
 - (e) pledging the asset to secure a loan; and
 - (f) holding the asset.
- 34 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs B64–B76).

Performance obligations satisfied over time

- 35 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:
- (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3–B4);

- (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
 - (c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).
- 36 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs B6–B8 provide guidance for assessing whether an asset has an alternative use to an entity.
- 37 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs B9–B13 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

Performance obligations satisfied at a point in time

- 38 If a performance obligation is not satisfied over time in accordance with paragraphs 35–37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31–34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:
- (a) The entity has a present right to payment for the asset—if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
 - (b) The customer has legal title to the asset—legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
 - (c) The entity has transferred physical possession of the asset—the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs B64–B76, B77–B78 and B79–B82 provide guidance on accounting for

repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.

- (d) The customer has the significant risks and rewards of ownership of the asset—the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- (e) The customer has accepted the asset—the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83–B86.

Measuring progress towards complete satisfaction of a performance obligation

- 39 For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation).
- 40 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

Methods for measuring progress

- 41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14–B19 provide guidance for using output methods and input methods to measure an entity's progress towards complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.
- 42 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.
- 43 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Reasonable measures of progress

- 44 An entity shall recognise revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress towards complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

- 45 In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognise revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

Measurement

- 46 **When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 56–58) that is allocated to that performance obligation.**

Determining the transaction price

- 47 **An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.**
- 48 The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:
- (a) variable consideration (see paragraphs 50–55 and 59);
 - (b) constraining estimates of variable consideration (see paragraphs 56–58);
 - (c) the existence of a significant financing component in the contract (see paragraphs 60–65);
 - (d) non-cash consideration (see paragraphs 66–69); and
 - (e) consideration payable to a customer (see paragraphs 70–72).
- 49 For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

Variable consideration

- 50 If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.
- 51 An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.
- 52 The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:
- (a) the customer has a valid expectation arising from an entity's customary business practices, published policies or specific statements that the entity will accept an

amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

- (b) other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.
- 53 An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:
- (a) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
 - (b) The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).
- 54 An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

Refund liabilities

- 55 An entity shall recognise a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (ie amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the *contract liability*) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs B20–B27.

Constraining estimates of variable consideration

- 56 An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
- 57 In assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:
- (a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

- (b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
 - (c) the entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
 - (d) the entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
 - (e) the contract has a large number and broad range of possible consideration amounts.
- 58 An entity shall apply paragraph B63 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a licence of intellectual property.

Reassessment of variable consideration

- 59 At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 87–90.

The existence of a significant financing component in the contract

- 60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.
- 61 The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:
- (a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
 - (b) the combined effect of both of the following:
 - (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
 - (ii) the prevailing interest rates in the relevant market.
- 62 Notwithstanding the assessment in paragraph 61, a contract with a customer would not have a significant financing component if any of the following factors exist:
- (a) the customer paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer.

- (b) a substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).
 - (c) the difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.
- 63 As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.
- 64 To meet the objective in paragraph 61 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).
- 65 An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Interest revenue or interest expense is recognised only to the extent that a *contract asset* (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

Non-cash consideration

- 66 To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of non-cash consideration) at fair value.
- 67 If an entity cannot reasonably estimate the fair value of the non-cash consideration, the entity shall measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.
- 68 The fair value of the non-cash consideration may vary because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). If the fair value of the non-cash consideration promised by a customer varies for reasons other than only the form of the consideration (for example, the fair value could vary because of the entity's performance), an entity shall apply the requirements in paragraphs 56–58.
- 69 If a customer contributes goods or services (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer.

Consideration payable to a customer

- 70 Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26–30) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 50–58.
- 71 If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.
- 72 Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:
- (a) the entity recognises revenue for the transfer of the related goods or services to the customer; and
 - (b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Allocating the transaction price to performance obligations

- 73 **The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.**
- 74 To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative stand-alone selling price basis in accordance with paragraphs 76–80, except as specified in paragraphs 81–83 (for allocating discounts) and paragraphs 84–86 (for allocating consideration that includes variable amounts).
- 75 Paragraphs 76–86 do not apply if a contract has only one performance obligation. However, paragraphs 84–86 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 22(b) and the promised consideration includes variable amounts.

Allocation based on stand-alone selling prices

- 76 To allocate the transaction price to each performance obligation on a relative stand-alone selling price basis, an entity shall determine the stand-alone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices.

- 77 The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the stand-alone selling price of that good or service.
- 78 If a stand-alone selling price is not directly observable, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 73. When estimating a stand-alone selling price, an entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximise the use of observable inputs and apply estimation methods consistently in similar circumstances.
- 79 Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:
- (a) Adjusted market assessment approach—an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
 - (b) Expected cost plus a margin approach—an entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
 - (c) Residual approach—an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 78, the stand-alone selling price of a good or service only if one of the following criteria is met:
 - (i) the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (ie the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or
 - (ii) the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis (ie the selling price is uncertain).
- 80 A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. For example, an entity may use a residual approach to estimate the aggregate stand-alone selling price for those promised goods or services with highly variable or uncertain stand-alone selling prices and then use another method to estimate the stand-alone selling prices of the individual goods or services relative to that estimated aggregate stand-alone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the stand-alone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in paragraph 73 and the requirements for estimating stand-alone selling prices in paragraph 78.

Allocation of a discount

- 81 A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds

the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 82 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of the underlying distinct goods or services.

- 82 An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:
- (a) the entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;
 - (b) the entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and
 - (c) the discount attributable to each bundle of goods or services described in paragraph 82(b) is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.
- 83 If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 82, an entity shall allocate the discount before using the residual approach to estimate the stand-alone selling price of a good or service in accordance with paragraph 79(c).

Allocation of variable consideration

- 84 Variable consideration that is promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as either of the following:
- (a) one or more, but not all, performance obligations in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time); or
 - (b) one or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 22(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).
- 85 An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 22(b) if both of the following criteria are met:
- (a) the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
 - (b) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 73 when considering all of the performance obligations and payment terms in the contract.
- 86 The allocation requirements in paragraphs 73–83 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 85.

Changes in the transaction price

- 87 After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.
- 88 An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes.
- 89 An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 22(b) only if the criteria in paragraph 85 on allocating variable consideration are met.
- 90 An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 18–21. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 87–89 to allocate the change in the transaction price in whichever of the following ways is applicable:
- (a) An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 21(a).
 - (b) In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 20, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (ie the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

Contract costs

Incremental costs of obtaining a contract

- 91 **An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.**
- 92 The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).
- 93 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.
- 94 As a practical expedient, an entity may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

Costs to fulfil a contract

- 95 If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example, HKAS 2 *Inventories*, HKAS 16 *Property, Plant and Equipment* or HKAS 38 *Intangible Assets*), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:
- (a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
 - (b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
 - (c) the costs are expected to be recovered.
- 96 For costs incurred in fulfilling a contract with a customer that are within the scope of another Standard, an entity shall account for those costs in accordance with those other Standards.
- 97 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:
- (a) direct labour (for example, salaries and wages of employees who provide the promised services directly to the customer);
 - (b) direct materials (for example, supplies used in providing the promised services to a customer);
 - (c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract);
 - (d) costs that are explicitly chargeable to the customer under the contract; and
 - (e) other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).
- 98 An entity shall recognise the following costs as expenses when incurred:
- (a) general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 97);
 - (b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;
 - (c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and
 - (d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Amortisation and impairment

- 99 An asset recognised in accordance with paragraph 91 or 95 shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 95(a)).
- 100 An entity shall update the amortisation to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with HKAS 8.
- 101 An entity shall recognise an impairment loss in profit or loss to the extent that the carrying amount of an asset recognised in accordance with paragraph 91 or 95 exceeds:
- (a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
 - (b) the costs that relate directly to providing those goods or services and that have not been recognised as expenses (see paragraph 97).
- 102 For the purposes of applying paragraph 101 to determine the amount of consideration that an entity expects to receive, an entity shall use the principles for determining the transaction price (except for the requirements in paragraphs 56–58 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.
- 103 Before an entity recognises an impairment loss for an asset recognised in accordance with paragraph 91 or 95, the entity shall recognise any impairment loss for assets related to the contract that are recognised in accordance with another Standard (for example, HKAS 2, HKAS 16 and HKAS 38). After applying the impairment test in paragraph 101, an entity shall include the resulting carrying amount of the asset recognised in accordance with paragraph 91 or 95 in the carrying amount of the cash-generating unit to which it belongs for the purpose of applying HKAS 36 *Impairment of Assets* to that cash-generating unit.
- 104 An entity shall recognise in profit or loss a reversal of some or all of an impairment loss previously recognised in accordance with paragraph 101 when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.

Presentation

- 105 **When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.**
- 106 If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (ie a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.
- 107 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has

transferred to a customer. An entity shall assess a contract asset for impairment in accordance with HKFRS 9. An impairment of a contract asset shall be measured, presented and disclosed on the same basis as a financial asset that is within the scope of HKFRS 9 (see also paragraph 113(b)).

- 108 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognise a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with HKFRS 9. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with HKFRS 9 and the corresponding amount of revenue recognised shall be presented as an expense (for example, as an impairment loss).
- 109 This Standard uses the terms 'contract asset' and 'contract liability' but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

Disclosure

- 110 **The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:**
- (a) **its contracts with customers (see paragraphs 113–122);**
 - (b) **the significant judgements, and changes in the judgements, made in applying this Standard to those contracts (see paragraphs 123–126); and**
 - (c) **any assets recognised from the costs to obtain or fulfil a contract with a customer in accordance with paragraph 91 or 95 (see paragraphs 127–128).**
- 111 An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.
- 112 An entity need not disclose information in accordance with this Standard if it has provided the information in accordance with another Standard.

Contracts with customers

- 113 An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income in accordance with other Standards:
- (a) revenue recognised from contracts with customers, which the entity shall disclose separately from its other sources of revenue; and
 - (b) any impairment losses recognised (in accordance with HKFRS 9) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses from other contracts.

Disaggregation of revenue

- 114 An entity shall disaggregate revenue recognised from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs B87–B89 when selecting the categories to use to disaggregate revenue.
- 115 In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 114) and revenue information that is disclosed for each reportable segment, if the entity applies HKFRS 8 *Operating Segments*.

Contract balances

- 116 An entity shall disclose all of the following:
- (a) the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed;
 - (b) revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; and
 - (c) revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).
- 117 An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 119(a)) relates to the typical timing of payment (see paragraph 119(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.
- 118 An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:
- (a) changes due to business combinations;
 - (b) cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained) or a contract modification;
 - (c) impairment of a contract asset;
 - (d) a change in the time frame for a right to consideration to become unconditional (ie for a contract asset to be reclassified to a receivable); and
 - (e) a change in the time frame for a performance obligation to be satisfied (ie for the recognition of revenue arising from a contract liability).

Performance obligations

- 119 An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:
- (a) when the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered or upon completion of

service), including when performance obligations are satisfied in a bill-and-hold arrangement;

- (b) the significant payment terms (for example, when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 56–58);
- (c) the nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (ie if the entity is acting as an agent);
- (d) obligations for returns, refunds and other similar obligations; and
- (e) types of warranties and related obligations.

Transaction price allocated to the remaining performance obligations

120 An entity shall disclose the following information about its remaining performance obligations:

- (a) the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period; and
- (b) an explanation of when the entity expects to recognise as revenue the amount disclosed in accordance with paragraph 120(a), which the entity shall disclose in either of the following ways:
 - (i) on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations; or
 - (ii) by using qualitative information.

121 As a practical expedient, an entity need not disclose the information in paragraph 120 for a performance obligation if either of the following conditions is met:

- (a) the performance obligation is part of a contract that has an original expected duration of one year or less; or
- (b) the entity recognises revenue from the satisfaction of the performance obligation in accordance with paragraph B16.

122 An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 121 and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 120. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 56–58).

Significant judgements in the application of this Standard

123 An entity shall disclose the judgements, and changes in the judgements, made in applying this Standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgements, and changes in the judgements, used in determining both of the following:

- (a) the timing of satisfaction of performance obligations (see paragraphs 124–125); and

- (b) the transaction price and the amounts allocated to performance obligations (see paragraph 126).

Determining the timing of satisfaction of performance obligations

124 For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

- (a) the methods used to recognise revenue (for example, a description of the output methods or input methods used and how those methods are applied); and
- (b) an explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

125 For performance obligations satisfied at a point in time, an entity shall disclose the significant judgements made in evaluating when a customer obtains control of promised goods or services.

Determining the transaction price and the amounts allocated to performance obligations

126 An entity shall disclose information about the methods, inputs and assumptions used for all of the following:

- (a) determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration;
- (b) assessing whether an estimate of variable consideration is constrained;
- (c) allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable); and
- (d) measuring obligations for returns, refunds and other similar obligations.

Assets recognised from the costs to obtain or fulfil a contract with a customer

127 An entity shall describe both of the following:

- (a) the judgements made in determining the amount of the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraph 91 or 95); and
- (b) the method it uses to determine the amortisation for each reporting period.

128 An entity shall disclose all of the following:

- (a) the closing balances of assets recognised from the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraph 91 or 95), by main category of asset (for example, costs to obtain contracts with customers, pre-contract costs and setup costs); and
- (b) the amount of amortisation and any impairment losses recognised in the reporting period.

Practical expedients

- 129 If an entity elects to use the practical expedient in either paragraph 63 (about the existence of a significant financing component) or paragraph 94 (about the incremental costs of obtaining a contract), the entity shall disclose that fact.

Appendix A

Defined terms

This appendix is an integral part of the Standard.

contract	An agreement between two or more parties that creates enforceable rights and obligations.
contract asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
contract liability	An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
performance obligation	A promise in a contract with a customer to transfer to the customer either: (a) a good or service (or a bundle of goods or services) that is distinct; or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
revenue	Income arising in the course of an entity's ordinary activities.
stand-alone selling price (of a good or service)	The price at which an entity would sell a promised good or service separately to a customer .
transaction price (for a contract with a customer)	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer , excluding amounts collected on behalf of third parties.

Appendix B

Application Guidance

This appendix is an integral part of the Standard. It describes the application of paragraphs 1–129 and has the same authority as the other parts of the Standard.

- B1 This application guidance is organised into the following categories:
- (a) performance obligations satisfied over time (paragraphs B2–B13);
 - (b) methods for measuring progress towards complete satisfaction of a performance obligation (paragraphs B14–B19);
 - (c) sale with a right of return (paragraphs B20–B27);
 - (d) warranties (paragraphs B28–B33);
 - (e) principal versus agent considerations (paragraphs B34–B38);
 - (f) customer options for additional goods or services (paragraphs B39–B43);
 - (g) customers' unexercised rights (paragraphs B44–B47);
 - (h) non-refundable upfront fees (and some related costs) (paragraphs B48–B51);
 - (i) licensing (paragraphs B52–B63B);
 - (j) repurchase agreements (paragraphs B64–B76);
 - (k) consignment arrangements (paragraphs B77–B78);
 - (l) bill-and-hold arrangements (paragraphs B79–B82);
 - (m) customer acceptance (paragraphs B83–B86); and
 - (n) disclosure of disaggregated revenue (paragraphs B87–B89).

Performance obligations satisfied over time

- B2 In accordance with paragraph 35, a performance obligation is satisfied over time if one of the following criteria is met:
- (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3–B4);
 - (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
 - (c) the entity's performance does not create an asset with an alternative use to the entity (see paragraphs B6–B8) and the entity has an enforceable right to payment for performance completed to date (see paragraphs B9–B13).

Simultaneous receipt and consumption of the benefits of the entity's performance (paragraph 35(a))

- B3 For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include

routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

- B4 For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation to the customer. In determining whether another entity would not need to substantially re-perform the work the entity has completed to date, an entity shall make both of the following assumptions:
- (a) disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity; and
 - (b) presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

Customer controls the asset as it is created or enhanced (paragraph 35(b))

- B5 In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 35(b), an entity shall apply the requirements for control in paragraphs 31–34 and 38. The asset that is being created or enhanced (for example, a work-in-progress asset) could be either tangible or intangible.

Entity's performance does not create an asset with an alternative use (paragraph 35(c))

- B6 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.
- B7 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.
- B8 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

Right to payment for performance completed to date (paragraph 35(c))

- B9 In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as

promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

- (a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or
- (b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

B10 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

B11 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

B12 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

- (a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;
- (b) relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or
- (c) an entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

B13 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for

example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.

Methods for measuring progress towards complete satisfaction of a performance obligation

B14 Methods that can be used to measure an entity's progress towards complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 35–37 include the following:

- (a) output methods (see paragraphs B15–B17); and
- (b) input methods (see paragraphs B18–B19).

Output methods

B15 Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity shall consider whether the output selected would faithfully depict the entity's performance towards complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in progress or finished goods controlled by the customer that are not included in the measurement of the output.

B16 As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognise revenue in the amount to which the entity has a right to invoice.

B17 The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

Input methods

B18 Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.

B19 A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- (a) When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognise revenue on the basis of costs incurred that are attributable to significant inefficiencies in the

entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labour or other resources that were incurred to satisfy the performance obligation).

- (b) When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognise revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:
- (i) the good is not distinct;
 - (ii) the customer is expected to obtain control of the good significantly before receiving services related to the good;
 - (iii) the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
 - (iv) the entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs B34–B38).

Sale with a right of return

- B20 In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:
- (a) a full or partial refund of any consideration paid;
 - (b) a credit that can be applied against amounts owed, or that will be owed, to the entity; and
 - (c) another product in exchange.
- B21 To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise all of the following:
- (a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);
 - (b) a refund liability; and
 - (c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.
- B22 An entity's promise to stand ready to accept a returned product during the return period shall not be accounted for as a performance obligation in addition to the obligation to provide a refund.
- B23 An entity shall apply the requirements in paragraphs 47–72 (including the requirements for constraining estimates of variable consideration in paragraphs 56–58) to determine the amount of consideration to which the entity expects to be entitled (ie excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity shall not recognise revenue when it transfers products to customers but shall recognise those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity shall update its assessment of amounts for which it expects to be entitled in exchange for the

transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognised.

- B24 An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognise corresponding adjustments as revenue (or reductions of revenue).
- B25 An asset recognised for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned. An entity shall present the asset separately from the refund liability.
- B26 Exchanges by customers of one product for another of the same type, quality, condition and price (for example, one colour or size for another) are not considered returns for the purposes of applying this Standard.
- B27 Contracts in which a customer may return a defective product in exchange for a functioning product shall be evaluated in accordance with the guidance on warranties in paragraphs B28–B33.

Warranties

- B28 It is common for an entity to provide (in accordance with the contract, the law or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.
- B29 If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity shall account for the promised warranty as a performance obligation in accordance with paragraphs 22–30 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 73–86.
- B30 If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.
- B31 In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity shall consider factors such as:
- (a) Whether the warranty is required by law—if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
 - (b) The length of the warranty coverage period—the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

- (c) The nature of the tasks that the entity promises to perform—if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.
- B32 If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity shall allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity shall account for both of the warranties together as a single performance obligation.
- B33 A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity's products does not give rise to a performance obligation. The entity shall account for such obligations in accordance with HKAS 37.

Principal versus agent considerations

- B34 When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 27–30). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.
- B34A To determine the nature of its promise (as described in paragraph B34), the entity shall:
- (a) identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party (see paragraph 26)); and
 - (b) assess whether it controls (as described in paragraph 33) each specified good or service before that good or service is transferred to the customer.
- B35 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.
- B35A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:
- (a) a good or another asset from the other party that it then transfers to the customer.
 - (b) a right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

- (c) a good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 29(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which includes goods or services from other parties) and directs their use to create the combined output that is the specified good or service.
- B35B When (or as) an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.
- B36 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.
- B37 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal (see paragraph B35)) include, but are not limited to, the following:
- (a) the entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
 - (b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits itself to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
 - (c) the entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.
- B37A The indicators in paragraph B37 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.
- B38 If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (ie the entity is no longer acting as the principal), the entity shall not recognise revenue for that performance obligation. Instead, the entity shall evaluate whether to recognise revenue for satisfying a

performance obligation to obtain a contract for the other party (ie whether the entity is acting as an agent).

Customer options for additional goods or services

- B39 Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options or other discounts on future goods or services.
- B40 If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services and the entity recognises revenue when those future goods or services are transferred or when the option expires.
- B41 If a customer has the option to acquire an additional good or service at a price that would reflect the stand-alone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it shall account for in accordance with this Standard only when the customer exercises the option to purchase the additional goods or services.
- B42 Paragraph 74 requires an entity to allocate the transaction price to performance obligations on a relative stand-alone selling price basis. If the stand-alone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity shall estimate it. That estimate shall reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:
- (a) any discount that the customer could receive without exercising the option; and
 - (b) the likelihood that the option will be exercised.
- B43 If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the stand-alone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

Customers' unexercised rights

- B44 In accordance with paragraph 106, upon receipt of a prepayment from a customer, an entity shall recognise a contract liability in the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future. An entity shall derecognise that contract liability (and recognise revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation.
- B45 A customer's non-refundable prepayment to an entity gives the customer a right to receive a good or service in the future (and obliges the entity to stand ready to transfer a good or service). However, customers may not exercise all of their contractual rights. Those unexercised rights are often referred to as breakage.
- B46 If an entity expects to be entitled to a breakage amount in a contract liability, the entity shall recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity shall recognise the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine

whether an entity expects to be entitled to a breakage amount, the entity shall consider the requirements in paragraphs 56–58 on constraining estimates of variable consideration.

- B47 An entity shall recognise a liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights for which the entity is required to remit to another party, for example, a government entity in accordance with applicable unclaimed property laws.

Non-refundable upfront fees (and some related costs)

- B48 In some contracts, an entity charges a customer a non-refundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunication contracts, setup fees in some services contracts and initial fees in some supply contracts.
- B49 To identify performance obligations in such contracts, an entity shall assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer (see paragraph 25). Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognised as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right as described in paragraph B40.
- B50 If the non-refundable upfront fee relates to a good or service, the entity shall evaluate whether to account for the good or service as a separate performance obligation in accordance with paragraphs 22–30.
- B51 An entity may charge a non-refundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 25). If those setup activities do not satisfy a performance obligation, the entity shall disregard those activities (and related costs) when measuring progress in accordance with paragraph B19. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity shall assess whether costs incurred in setting up a contract have resulted in an asset that shall be recognised in accordance with paragraph 95.

Licensing

- B52 A licence establishes a customer's rights to the intellectual property of an entity. Licences of intellectual property may include, but are not limited to, licenses of any of the following:
- (a) software and technology;
 - (b) motion pictures, music and other forms of media and entertainment;
 - (c) franchises; and
 - (d) patents, trademarks and copyrights.
- B53 In addition to a promise to grant a licence (or licenses) to a customer, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by an entity's customary business practices, published policies or specific statements (see paragraph 24). As with other types of contracts, when a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies paragraphs 22–30 to identify each of the performance obligations in the contract.

- B54 If the promise to grant a licence is not distinct from other promised goods or services in the contract in accordance with paragraphs 26–30, an entity shall account for the promise to grant a licence and those other promised goods or services together as a single performance obligation. Examples of licences that are not distinct from other goods or services promised in the contract include the following:
- (a) a licence that forms a component of a tangible good and that is integral to the functionality of the good; and
 - (b) a licence that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a licence, the customer to access content).
- B55 If the licence is not distinct, an entity shall apply paragraphs 31–38 to determine whether the performance obligation (which includes the promised licence) is a performance obligation that is satisfied over time or satisfied at a point in time.
- B56 If the promise to grant the licence is distinct from the other promised goods or services in the contract and, therefore, the promise to grant the licence is a separate performance obligation, an entity shall determine whether the licence transfers to a customer either at a point in time or over time. In making this determination, an entity shall consider whether the nature of the entity's promise in granting the licence to a customer is to provide the customer with either:
- (a) a right to access the entity's intellectual property as it exists throughout the licence period; or
 - (b) a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted.

Determining the nature of the entity's promise

- B57 [Deleted]
- B58 The nature of an entity's promise in granting a licence is a promise to provide a right to access the entity's intellectual property if all of the following criteria are met:
- (a) the contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights (see paragraph B59 and B59A);
 - (b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph B58(a); and
 - (c) those activities do not result in the transfer of a good or a service to the customer as those activities occur (see paragraph 25).
- B59 Factors that may indicate that a customer could reasonably expect that an entity will undertake activities that significantly affect the intellectual property include the entity's customary business practices, published policies or specific statements. Although not determinative, the existence of a shared economic interest (for example, a sales-based royalty) between the entity and the customer related to the intellectual property to which the customer has rights may also indicate that the customer could reasonably expect that the entity will undertake such activities.
- B59A An entity's activities significantly affect the intellectual property to which the customer has rights when either:
- (a) those activities are expected to significantly change the form (for example, the design or content) or the functionality (for example, the ability to perform a function or task) of the intellectual property; or

- (b) the ability of the customer to obtain benefit from the intellectual property is substantially derived from, or dependent upon, those activities. For example, the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property.

Accordingly, if the intellectual property to which the customer has rights has significant stand-alone functionality, a substantial portion of the benefit of that intellectual property is derived from that functionality. Consequently, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities significantly change its form or functionality. Types of intellectual property that often have significant stand-alone functionality include software, biological compounds or drug formulas, and completed media content (for example, films, television shows and music recordings).

- B60 If the criteria in paragraph B58 are met, an entity shall account for the promise to grant a licence as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 35(a)). An entity shall apply paragraphs 39–45 to select an appropriate method to measure its progress towards complete satisfaction of that performance obligation to provide access.
- B61 If the criteria in paragraph B58 are not met, the nature of an entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists (in terms of form and functionality) at the point in time at which the licence is granted to the customer. This means that the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence transfers. An entity shall account for the promise to provide a right to use the entity's intellectual property as a performance obligation satisfied at a point in time. An entity shall apply paragraph 38 to determine the point in time at which the licence transfers to the customer. However, revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. For example, if a software licence period begins before an entity provides (or otherwise makes available) to the customer a code that enables the customer to immediately use the software, the entity would not recognise revenue before that code has been provided (or otherwise made available).
- B62 An entity shall disregard the following factors when determining whether a licence provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:
- (a) Restrictions of time, geographical region or use—those restrictions define the attributes of the promised licence, rather than define whether the entity satisfies its performance obligation at a point in time or over time.
 - (b) Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use—a promise to defend a patent right is not a performance obligation because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the licence transferred meets the specifications of the licence promised in the contract.

Sales-based or usage-based royalties

- B63 Notwithstanding the requirements in paragraphs 56–59, an entity shall recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:
- (a) the subsequent sale or usage occurs; and

- (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).
- B63A The requirement for a sales-based or usage-based royalty in paragraph B63 applies when the royalty relates only to a licence of intellectual property or when a licence of intellectual property is the predominant item to which the royalty relates (for example, the licence of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates).
- B63B When the requirement in paragraph B63A is met, revenue from a sales-based or usage-based royalty shall be recognised wholly in accordance with paragraph B63. When the requirement in paragraph B63A is not met, the requirements on variable consideration in paragraphs 50–59 apply to the sales-based or usage-based royalty.

Repurchase agreements

- B64 A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.
- B65 Repurchase agreements generally come in three forms:
- (a) an entity's obligation to repurchase the asset (a forward);
 - (b) an entity's right to repurchase the asset (a call option); and
 - (c) an entity's obligation to repurchase the asset at the customer's request (a put option).

A forward or a call option

- B66 If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity shall account for the contract as either of the following:
- (a) a lease in accordance with HKAS 17 *Leases* if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset; or
 - (b) a financing arrangement in accordance with paragraph B68 if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.
- B67 When comparing the repurchase price with the selling price, an entity shall consider the time value of money.
- B68 If the repurchase agreement is a financing arrangement, the entity shall continue to recognise the asset and also recognise a financial liability for any consideration received from the customer. The entity shall recognise the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).
- B69 If the option lapses unexercised, an entity shall derecognise the liability and recognise revenue.

A put option

- B70 If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity shall consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity shall account for the agreement as a lease in accordance with HKAS 17.
- B71 To determine whether a customer has a significant economic incentive to exercise its right, an entity shall consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.
- B72 If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity shall account for the agreement as if it were the sale of a product with a right of return as described in paragraphs B20–B27.
- B73 If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, shall be accounted for as described in paragraph B68.
- B74 If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity shall account for the agreement as if it were the sale of a product with a right of return as described in paragraphs B20–B27.
- B75 When comparing the repurchase price with the selling price, an entity shall consider the time value of money.
- B76 If the option lapses unexercised, an entity shall derecognise the liability and recognise revenue.

Consignment arrangements

- B77 When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity shall evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity shall not recognise revenue upon delivery of a product to another party if the delivered product is held on consignment.
- B78 Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:
- (a) the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;
 - (b) the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and
 - (c) the dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Bill-and-hold arrangements

- B79 A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.
- B80 An entity shall determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 38). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.
- B81 In addition to applying the requirements in paragraph 38, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:
- (a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
 - (b) the product must be identified separately as belonging to the customer;
 - (c) the product currently must be ready for physical transfer to the customer; and
 - (d) the entity cannot have the ability to use the product or to direct it to another customer.
- B82 If an entity recognises revenue for the sale of a product on a bill-and-hold basis, the entity shall consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 22–30 to which the entity shall allocate a portion of the transaction price in accordance with paragraphs 73–86.

Customer acceptance

- B83 In accordance with paragraph 38(e), a customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity shall consider such clauses when evaluating when a customer obtains control of a good or service.
- B84 If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognised before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.
- B85 However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the

entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

- B86 If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

Disclosure of disaggregated revenue

- B87 Paragraph 114 requires an entity to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 114 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.
- B88 When selecting the type of category (or categories) to use to disaggregate revenue, an entity shall consider how information about the entity's revenue has been presented for other purposes, including all of the following:
- (a) disclosures presented outside the financial statements (for example, in earnings releases, annual reports or investor presentations);
 - (b) information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and
 - (c) other information that is similar to the types of information identified in paragraph B88(a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.
- B89 Examples of categories that might be appropriate include, but are not limited to, all of the following:
- (a) type of good or service (for example, major product lines);
 - (b) geographical region (for example, country or region);
 - (c) market or type of customer (for example, government and non-government customers);
 - (d) type of contract (for example, fixed-price and time-and-materials contracts);
 - (e) contract duration (for example, short-term and long-term contracts);
 - (f) timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time); and
 - (g) sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Appendix C

Effective date and transition

This appendix is an integral part of the Standard and has the same authority as the other parts of the Standard.

Effective date

- C1 An entity shall apply this Standard for annual reporting periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies this Standard earlier, it shall disclose that fact.
- C1B *Clarifications to HKFRS 15 Revenue from Contracts with Customers*, issued in June 2016, amended paragraphs 26, 27, 29, B1, B34–B38, B52–B53, B58, C2, C5 and C7, deleted paragraph B57 and added paragraphs B34A, B35A, B35B, B37A, B59A, B63A, B63B, C7A and C8A. An entity shall apply those amendments for annual reporting periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Transition

- C2 For the purposes of the transition requirements in paragraphs C3–C8A:
- (a) the date of initial application is the start of the reporting period in which an entity first applies this Standard; and
 - (b) a completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with HKAS 11 *Construction Contracts*, HKAS 18 *Revenue* and related Interpretations.
- C3 An entity shall apply this Standard using one of the following two methods:
- (a) retrospectively to each prior reporting period presented in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to the expedients in paragraph C5; or
 - (b) retrospectively with the cumulative effect of initially applying this Standard recognised at the date of initial application in accordance with paragraphs C7–C8.
- C4 Notwithstanding the requirements of paragraph 28 of HKAS 8, when this Standard is first applied, an entity need only present the quantitative information required by paragraph 28(f) of HKAS 8 for the annual period immediately preceding the first annual period for which this Standard is applied (the ‘immediately preceding period’) and only if the entity applies this Standard retrospectively in accordance with paragraph C3(a). An entity may also present this information for the current period or for earlier comparative periods, but is not required to do so.
- C5 An entity may use one or more of the following practical expedients when applying this Standard retrospectively in accordance with paragraph C3(a):
- (a) for completed contracts, an entity need not restate contracts that:
 - (i) begin and end within the same annual reporting period; or
 - (ii) are completed contracts at the beginning of the earliest period presented.

- (b) for completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
 - (c) for contracts that were modified before the beginning of the earliest period presented, an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 20–21. Instead, an entity shall reflect the aggregate effect of all of the modifications that occur before the beginning of the earliest period presented when:
 - (i) identifying the satisfied and unsatisfied performance obligations;
 - (ii) determining the transaction price; and
 - (iii) allocating the transaction price to the satisfied and unsatisfied performance obligations.
 - (d) for all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue (see paragraph 120).
- C6 For any of the practical expedients in paragraph C5 that an entity uses, the entity shall apply that expedient consistently to all contracts within all reporting periods presented. In addition, the entity shall disclose all of the following information:
- (a) the expedients that have been used; and
 - (b) to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.
- C7 If an entity elects to apply this Standard retrospectively in accordance with paragraph C3(b), the entity shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. Under this transition method, an entity may elect to apply this Standard retrospectively only to contracts that are not completed contracts at the date of initial application (for example, 1 January 2018 for an entity with a 31 December year-end).
- C7A An entity applying this Standard retrospectively in accordance with paragraph C3(b) may also use the practical expedient described in paragraph C5(c), either:
- (a) for all contract modifications that occur before the beginning of the earliest period presented; or
 - (b) for all contract modifications that occur before the date of initial application.
- If an entity uses this practical expedient, the entity shall apply the expedient consistently to all contracts and disclose the information required by paragraph C6.
- C8 For reporting periods that include the date of initial application, an entity shall provide both of the following additional disclosures if this Standard is applied retrospectively in accordance with paragraph C3(b):
- (a) the amount by which each financial statement line item is affected in the current reporting period by the application of this Standard as compared to HKAS 11, HKAS 18 and related Interpretations that were in effect before the change; and
 - (b) an explanation of the reasons for significant changes identified in C8(a).
- C8A An entity shall apply *Clarifications to HKFRS 15* (see paragraph C1B) retrospectively in accordance with HKAS 8. In applying the amendments retrospectively, an entity shall apply the amendments as if they had been included in HKFRS 15 at the date of initial application. Consequently, an entity does not apply the amendments to reporting periods

or to contracts to which the requirements of HKFRS 15 are not applied in accordance with paragraphs C2–C8. For example, if an entity applies HKFRS 15 in accordance with paragraph C3(b) only to contracts that are not completed contracts at the date of initial application, the entity does not restate the completed contracts at the date of initial application of HKFRS 15 for the effects of these amendments.

References to HKFRS 9

- C9 If an entity applies this Standard but does not yet apply HKFRS 9 *Financial Instruments*, any reference in this Standard to HKFRS 9 shall be read as a reference to HKAS 39 *Financial Instruments: Recognition and Measurement*.

Withdrawal of other Standards

- C10 This Standard supersedes the following Standards:
- (a) HKAS 11 *Construction Contracts*;
 - (b) HKAS 18 *Revenue*;
 - (c) HK(IFRIC)-Int 13 *Customer Loyalty Programmes*;
 - (d) HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate*;
 - (e) HK(IFRIC)-Int 18 *Transfers of Assets from Customers*; and
 - (f) HK(SIC)-Int 31 *Revenue—Barter Transactions Involving Advertising Services*.

Appendix D

Amendments to other Standards

This appendix sets out amendments to other HKFRSs that are a consequence of issuing HKFRS 15. An entity shall apply the amendments for annual periods beginning on or after 1 January 2018. If an entity applies HKFRS 15 for an earlier period, it shall apply the amendments for that earlier period.

The amendments contained in this appendix when this HKFRS was issued in 2014 have been incorporated into the relevant Standards.

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 15*

Revenue from Contracts with Customers



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Certified Public Accountants
香港會計師公會

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Basis for Conclusions on IFRS 15 *Revenue from Contracts with Customers*

HKFRS 15 is based on IFRS 15 *Revenue from Contracts with Customers*. In approving HKFRS 15, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 15. Accordingly, there are no significant differences between HKFRS 15 and IFRS 15. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 15 referred to below generally correspond with those in HKFRS 15.

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Basis for Conclusions on IFRS 15 *Revenue from Contracts with Customers*

This Basis for Conclusions accompanies, but is not part of, IFRS 15.

Introduction

- BC1 This Basis for Conclusions summarises the joint considerations of the International Accounting Standards Board (IASB) and the US national standard-setter, the Financial Accounting Standards Board (FASB), in reaching the conclusions in their standards, IFRS 15 *Revenue from Contracts with Customers* and Topic 606, which is introduced into the FASB *Accounting Standards Codification*® by the Accounting Standards Update 2014-09 *Revenue from Contracts with Customers*. It includes the reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC1A In April 2016, the IASB issued *Clarifications to IFRS 15 Revenue from Contracts with Customers*. The objective of these amendments is to clarify the IASB's intentions when developing the requirements in IFRS 15 but not to change the underlying principles of IFRS 15. Further details are contained in paragraphs BC27A–BC27H. In some cases, the boards made the same amendments to IFRS 15 and Topic 606. In other cases, the boards did not make the same amendments to the standards. The FASB also amended Topic 606 for issues for which the IASB concluded that it was not necessary to amend IFRS 15. The IASB added a further practical expedient to the transition requirements, which the FASB decided not to provide. Accordingly, Appendix A *Comparison of IFRS 15 and Topic 606* to this Basis for Conclusions has been updated to reflect the differences between the amendments to IFRS 15 and the amendments to Topic 606.

Overview

- BC2 IFRS 15 and Topic 606 are the result of the IASB's and the FASB's joint project to improve the financial reporting of revenue under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP). The boards undertook this project because their requirements for revenue needed improvement for the following reasons:
- (a) US GAAP comprised broad revenue recognition concepts and detailed guidance for particular industries or transactions, which often resulted in different accounting for economically similar transactions.
 - (b) the previous revenue Standards in IFRS had different principles and were sometimes difficult to understand and apply to transactions other than simple ones. In addition, IFRS had limited guidance on important topics such as revenue recognition for multiple-element arrangements. Consequently, some entities that were applying IFRS referred to parts of US GAAP to develop an appropriate revenue recognition accounting policy.
 - (c) the disclosures required under both IFRS and US GAAP were inadequate and often did not provide users of financial statements with information to sufficiently understand revenue arising from contracts with customers.
- BC3 IFRS 15 and Topic 606¹ eliminate those inconsistencies and weaknesses by providing a comprehensive revenue recognition model that applies to a wide range of transactions and industries. The comprehensive model also improves previous IFRS and US GAAP by:
- (a) providing a more robust framework for addressing revenue recognition issues;
 - (b) improving comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;

¹ Unless indicated otherwise, all references to IFRS 15 in this Basis for Conclusions can be read as also referring to Topic 606.

- (c) simplifying the preparation of financial statements by reducing the amount of guidance to which entities must refer; and
- (d) requiring enhanced disclosures to help users of financial statements better understand the nature, amount, timing and uncertainty of revenue that is recognised.

Background

- BC4 In December 2008, the boards published for public comment the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* and received more than 200 comment letters in response. In the Discussion Paper, the boards proposed the general principles of a contract-based revenue recognition model with a measurement approach that was based on an allocation of the transaction price. That revenue recognition model was developed after extensive discussions by the boards on alternative models for recognising and measuring revenue (see paragraphs BC16–BC27).
- BC5 Respondents to the Discussion Paper generally supported the objective of developing a comprehensive revenue recognition model for both IFRS and US GAAP. Most respondents also generally supported the recognition and measurement principles proposed in the Discussion Paper, which are the basic building blocks of the revenue recognition model. In particular, the Discussion Paper introduced the concepts that a contract contains performance obligations for the entity to transfer goods or services to a customer and that revenue is recognised when the entity satisfies its performance obligations as a result of the customer obtaining control of those goods or services.
- BC6 Respondents to the Discussion Paper were mainly concerned about the following proposals:
- (a) identifying performance obligations only on the basis of the timing of the transfer of the good or service to the customer. Respondents commented that this would be impractical, especially when many goods or services are transferred over time to the customer (for example, in construction contracts).
 - (b) using the concept of control to determine when a good or service is transferred. Respondents asked the boards to clarify the application of the concept of control to avoid the implication that the proposals would require completed contract accounting for all construction contracts (ie revenue is recognised only when the customer obtains legal title or physical possession of the completed asset).
- BC7 The boards considered those comments when developing the Exposure Draft *Revenue from Contracts with Customers* (the FASB's Exposure Draft was a proposed Accounting Standards Update), which was published in June 2010 (the '2010 Exposure Draft'). Nearly 1,000 comment letters were received from respondents representing a wide range of industries, including construction, manufacturing, telecommunications, technology, pharmaceutical, biotechnology, financial services, consulting, media and entertainment, energy and utilities, freight and logistics, and industries with significant franchising operations, such as hospitality and quick-service restaurant chains. The boards and their staffs also consulted extensively on the proposals in the 2010 Exposure Draft by participating in round-table discussions, conferences, working group sessions, discussion forums and one-to-one discussions that were held across all major geographical regions.
- BC8 The boards also received a substantial number of comment letters in response to a question asked by the FASB on whether the proposals should apply to non-public entities. Almost all of those comment letters were from respondents associated with sections of the US construction industry (for example, private construction contractors, accounting firms that serve those contractors and surety providers who use the financial statements of construction contractors when deciding whether to guarantee that those contractors will meet their obligations under a contract). Those respondents also raised concerns about the application of the proposed model to non-public entities. Those issues were considered and discussed separately by the FASB.
- BC9 With the exception of many of the responses from non-public entities in the construction industry, most of the feedback from the comment letters and from the consultation activities generally supported the boards' proposal for a comprehensive revenue recognition model for both IFRS and

US GAAP. Moreover, most respondents supported the core principle of that model, which was that an entity should recognise revenue to depict the transfer of goods or services to a customer in an amount that reflects the amount of consideration that the entity expects to receive for those goods or services.

BC10 Almost all respondents to the 2010 Exposure Draft indicated that the boards should clarify further the operation of the core principle. In particular, respondents were concerned about the application of the following:

- (a) the concept of control and, in particular, the application of the indicators of the transfer of control to service contracts and to contracts for the transfer of an asset over time to a customer as it is being constructed (for example, a work-in-progress asset).
- (b) the principle of distinct goods or services for identifying performance obligations in a contract. Many respondents were concerned that the proposed principle would lead to inappropriate disaggregation of the contract.

BC11 The boards addressed those concerns during the redeliberations of the proposals in the 2010 Exposure Draft. As the redeliberations of those proposals drew to a close, the boards decided to issue a revised Exposure Draft for public comment to provide interested parties with an opportunity to comment on the revisions that the boards had made since the 2010 Exposure Draft was published. The boards decided unanimously that it was appropriate to go beyond their established due process and re-expose their revised revenue proposals, because of the importance of revenue to all entities and to avoid unintended consequences in the recognition of revenue for specific contracts or industries. The revised Exposure Draft *Revenue from Contracts with Customers* was published in November 2011 (the '2011 Exposure Draft') and approximately 350 comment letters were received from respondents representing a wide range of industries. As in the case of the 2010 Exposure Draft, the boards and their staffs consulted extensively on the proposals in the 2011 Exposure Draft. This consultation also included all major geographical regions and occurred in a number of formats. Many of the discussions focused on detailed analyses related to the application of the revenue recognition model and the principles in the 2011 Exposure Draft.

BC12 Almost all respondents continued to support the core principle of the revenue recognition model, which is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Moreover, most of the feedback from the comment letters and from the consultation activities generally supported the revisions to the boards' proposed revenue recognition model in the 2011 Exposure Draft. However, respondents raised issues or questions on some of the proposals in the 2011 Exposure Draft. That feedback could be broadly divided into three categories:

- (a) requests for clarifications and further refinements—such as on the criteria for identifying performance obligations, determining when a performance obligation is satisfied over time and constraining estimates of variable consideration;
- (b) difficulties in the practical application of the requirements—such as on the time value of money (referred to as a significant financing component in IFRS 15) and the retrospective application of the proposed Standard; and
- (c) disagreement with some of the proposed requirements for the following topics:
 - (i) identifying onerous performance obligations;
 - (ii) disclosing information about revenue;
 - (iii) applying the requirements for licences; and
 - (iv) applying the allocation principles to contracts that are prevalent in the telecommunications industry.

- BC13 The boards addressed those concerns during the redeliberations of the proposals in the 2011 Exposure Draft. The boards' discussion of those concerns and their conclusions are included in the relevant sections of this Basis for Conclusions.

Why make the change?

- BC14 Throughout the project, some respondents questioned the need to replace the requirements for revenue recognition, particularly because those requirements seemed to work reasonably well in practice and provided useful information about the different types of contracts for which they were intended.
- (a) For US GAAP, some questioned whether a new revenue recognition model was necessary, because Accounting Standards Update No. 2009-13 *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements* resolved some of the issues that the Revenue Recognition project had originally intended to resolve. Furthermore, the *FASB Accounting Standards Codification®* (the Codification) had simplified the process of accessing and researching previous requirements for revenue.
 - (b) For IFRS, some indicated that the IASB could have improved, rather than replace, its previous revenue Standards by developing additional requirements for critical issues (for example, multiple-element arrangements).
- BC15 The boards acknowledged that it would have been possible to improve many of the previous revenue recognition requirements without replacing them. However, even after the changes to US GAAP mentioned in paragraph BC14(a), the requirements in US GAAP would have continued to result in inconsistent accounting for revenue and, consequently, would not have provided a robust framework for addressing revenue recognition issues in the future. Furthermore, amending the requirements would have failed to achieve one of the goals of the Revenue Recognition project, which was to develop a common revenue standard for IFRS and US GAAP that entities could apply consistently across industries, jurisdictions and capital markets. Because revenue is a crucial number to users of financial statements, the boards decided that a common standard on revenue for IFRS and US GAAP is an important step toward achieving the goal of a single set of high-quality global accounting standards. To be consistent with that goal, the boards noted that previous revenue recognition requirements in IFRS and US GAAP should not be used to supplement the principles in IFRS 15.

Alternative revenue recognition models

- BC16 During the early stages of their Revenue Recognition project, the boards considered various alternative revenue recognition models, including the following:
- (a) the basis for recognising revenue—specifically, whether an entity should recognise revenue only when it transfers a promised good or service to a customer (a contract-based revenue recognition principle) or when (or as) the entity undertakes a productive activity (which could be an activity that is undertaken regardless of whether a contract exists); and
 - (b) the basis for measuring revenue—specifically, whether revenue should be measured at an allocated customer consideration amount (ie the transaction price) or at a current exit price.

Basis for recognising revenue

- BC17 In the Discussion Paper, the boards proposed a principle to recognise revenue on the basis of the accounting for the asset or the liability arising from a contract with a customer. The boards had two reasons for developing a standard on revenue that applies only to contracts with customers. First, contracts to provide goods or services to customers are important economic phenomena and are crucial to most entities. Second, most previous revenue recognition requirements in IFRS and US GAAP focused on contracts with customers. The boards decided that focusing on the recognition and measurement of the asset or liability arising from a contract with a customer and the changes in that asset or liability over the life of the contract would bring discipline to the earnings process

approach. Consequently, it would result in entities recognising revenue more consistently than they did under previous revenue recognition requirements.

- BC18 Upon entering into a contract with a customer, an entity obtains rights to receive consideration from the customer and assumes obligations to transfer goods or services to the customer (performance obligations). The combination of those rights and performance obligations gives rise to a (net) asset or a (net) liability depending on the relationship between the remaining rights and the performance obligations. The contract is an asset (a contract asset) if the measure of the remaining rights exceeds the measure of the remaining performance obligations. Conversely, the contract is a liability (a contract liability) if the measure of the remaining performance obligations exceeds the measure of the remaining rights.
- BC19 By definition, revenue from a contract with a customer cannot be recognised until a contract exists. Conceptually, revenue recognition could occur at the point at which an entity enters into a contract with a customer. For an entity to recognise revenue at contract inception (before either party has performed), the measure of the entity's rights must exceed the measure of the entity's performance obligations. This could occur if the rights and obligations were measured at current exit prices and would lead to revenue recognition because of an increase in a contract asset. However, as described in paragraph BC25, the boards proposed in the Discussion Paper that performance obligations should be measured at the same amount as the rights in the contract at contract inception, thereby precluding the recognition of a contract asset and revenue at contract inception.
- BC20 Therefore, the boards decided that revenue should be recognised only when an entity transfers a promised good or service to a customer, thereby satisfying a performance obligation in the contract. That transfer results in revenue recognition, because upon satisfying a performance obligation an entity no longer has that obligation to provide the good or service. Consequently, its position in the contract increases—either its contract asset increases or its contract liability decreases—and that increase leads to revenue recognition.
- BC21 Although, conceptually, revenue arises from an increase in a contract asset or a decrease in a contract liability, the boards articulated the requirements in terms of the recognition and measurement of revenue rather than the recognition and measurement of the contract. The boards noted that focusing on the timing and amount of revenue from a contract with a customer would simplify the requirements. Feedback from respondents to the Discussion Paper and the 2010 and 2011 Exposure Drafts confirmed that view.
- BC22 Nearly all respondents to the Discussion Paper agreed with the boards' view that an entity generally should not recognise revenue if there is no contract with a customer. However, some respondents requested that the boards instead develop an activities model in which revenue would be recognised as the entity undertakes activities in producing or providing goods or services, regardless of whether those activities result in the transfer of goods or services to the customer. Those respondents reasoned that recognising revenue over time, for example, throughout long-term construction or other service contracts, regardless of whether goods or services are transferred to the customer, would provide users of financial statements with more useful information.
- BC23 However, the boards noted the following concerns about an activities model:
- (a) revenue recognition would not have been based on accounting for the contract. In an activities model, revenue arises from increases in the entity's assets, such as inventory or work-in-progress, rather than only from rights under a contract. Consequently, conceptually, an activities model does not require a contract with a customer for revenue recognition, although revenue recognition could be precluded until a contract exists. However, that would have resulted in revenue being recognised at contract inception for any activities completed to that point.
 - (b) it would have been counterintuitive to many users of financial statements. An entity would have recognised consideration as revenue when the customer had not received any promised goods or services in exchange.
 - (c) there would have been potential for abuse. An entity could have accelerated revenue recognition by increasing its activities (for example, production of inventory) at the end of a reporting period.

- (d) it would have resulted in a significant change to previous revenue recognition requirements and practices. In many of those requirements, revenue was recognised only when goods or services were transferred to the customer. For example, previous requirements in IFRS required revenue from the sale of a good to be recognised when the entity transferred ownership of the good to the customer. The boards also observed that the basis for percentage-of-completion accounting in previous revenue recognition requirements could be viewed as similar to the core principle in IFRS 15.

BC24 Accordingly, the boards did not develop an activities model and they maintained their view that a contract-based revenue recognition principle is the most appropriate principle for a general revenue recognition standard for contracts with customers.

Basis for measuring revenue

BC25 The boards decided that an allocated transaction price approach should be applied to measure performance obligations. Using that approach, an entity would allocate the transaction price to each performance obligation in the contract (see paragraphs BC181 and BC266). In the Discussion Paper, the boards considered an alternative approach to measure performance obligations directly at current exit prices. However, the boards rejected that approach for the following reasons:

- (a) an entity would have recognised revenue before transferring goods or services to the customer at contract inception if the measure of rights to consideration exceeded the measure of the remaining performance obligations. That would have been a typical occurrence at contract inception, because the transaction price often includes amounts that enable an entity to recover its costs to obtain a contract.
- (b) any errors in identifying or measuring performance obligations could have affected revenue recognised at contract inception.
- (c) a current exit price (ie the price that would be received to sell an asset or paid to transfer a liability) for the remaining performance obligations is typically not observable and an estimated current exit price could be complex and costly to prepare and difficult to verify.

BC26 Almost all respondents supported the boards' proposal to measure performance obligations using an allocated transaction price approach.

BC27 In the Discussion Paper, the boards also considered whether it would be appropriate to require an alternative measurement approach for some types of performance obligations (for example, performance obligations with highly variable outcomes, for which an allocated transaction price approach may not result in useful information). However, the boards decided that the benefits of accounting for all performance obligations within the scope of the requirements using the same measurement approach outweighed any concerns about using that approach for some types of performance obligations. The boards also noted that a common type of contract with customers that has highly variable outcomes would be an insurance contract, which is excluded from the scope of IFRS 15.

Clarifications to IFRS 15 (amendments issued in April 2016)

BC27A After issuing IFRS 15 and Topic 606 in May 2014, the boards formed the Transition Resource Group (TRG) for Revenue Recognition to support implementation of these standards. One of the objectives of the TRG is to inform the boards about implementation issues to help the boards determine what, if any, action should be undertaken to address those issues. The substantial majority of the submissions from stakeholders regarding the implementation of IFRS 15, as discussed by the TRG, were determined to be sufficiently addressed by the requirements in IFRS 15. However, the TRG's discussions on five topics indicated potential differences of views on how to implement the requirements and, therefore, were considered by the boards. Those topics were:

- (a) identifying performance obligations;
- (b) principal versus agent considerations;

- (c) licensing;
 - (d) collectability; and
 - (e) measuring non-cash consideration.
- BC27B The boards also received requests from some stakeholders for practical expedients in respect of the following:
- (a) accounting for contract modifications that occurred before transition to IFRS 15;
 - (b) for entities electing to use the full retrospective transition method, accounting for a contract completed under previous revenue Standards before transition to IFRS 15; and
 - (c) assessing whether a sales tax (or a similar tax) is collected on behalf of a third party.
- BC27C The boards discussed the five topics and the possible practical expedients, and each board decided to make amendments to clarify the requirements in IFRS 15 and Topic 606 respectively. As a result, the IASB issued *Clarifications to IFRS 15* in April 2016 making targeted amendments to IFRS 15 with respect to three of the five topics considered—identifying performance obligations, principal versus agent considerations and licensing. The IASB concluded that it was not necessary to amend IFRS 15 with respect to the other two topics—collectability and measuring non-cash consideration. In respect of the practical expedients, the IASB provided transition relief for modified contracts and completed contracts.
- BC27D In reaching its conclusions to make clarifying amendments and provide transition relief to IFRS 15, the IASB considered the need to balance being responsive to issues raised to help entities implement IFRS 15 but, at the same time, not creating a level of uncertainty about IFRS 15 to the extent that the IASB's actions might be disruptive to the implementation process. The IASB noted that, when new Standards are issued, there are always initial questions that arise. Those questions are generally resolved as entities, auditors and others work through them over time, and gain a better understanding of the new requirements. The IASB also considered the effect of any differences between its decisions and those made by the FASB.
- BC27E With these wider considerations in mind, the IASB decided to apply a high hurdle when considering whether to amend IFRS 15 and, thus, to minimise changes to the extent possible. On this basis, the IASB made clarifying amendments to IFRS 15 only when (a) it considered those amendments to be essential to clarifying the IASB's intentions when developing the requirements in IFRS 15; or (b) it viewed the benefits of retaining converged requirements as greater than any potential costs of amending the requirements.
- BC27F The FASB decided to make more extensive amendments to Topic 606, as explained in paragraph BC27G. The FASB issued amendments to the application guidance in Topic 606 on principal versus agent considerations, Accounting Standards Update (ASU) 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, in March 2016. The FASB is expected to issue two further ASUs:
- (a) one ASU for its amendments to the requirements with respect to identifying performance obligations and the application guidance on licensing; and
 - (b) another ASU for its amendments to the requirements in Topic 606 with respect to the other topics and the practical expedients.
- BC27G The FASB's amendments to Topic 606 are the same as the IASB's amendments to IFRS 15 with respect to (a) the requirements on identifying performance obligations relating to the determination of whether an entity's promise to transfer a good or service to a customer is distinct within the context of the contract; and (b) the application guidance on principal versus agent considerations. The FASB made further amendments regarding some other requirements on identifying performance obligations. In relation to licensing, the boards made the same clarifying amendments for sales-based and usage-based royalties. The boards decided to make different amendments to the application guidance relating to identifying the nature of an entity's promise in granting a licence. The FASB also decided to amend Topic 606 for other issues relating to licensing for which

the IASB decided not to make any amendments to IFRS 15. The FASB has also decided (a) to amend Topic 606 with respect to collectability and measuring non-cash consideration and (b) to provide an accounting policy election to present all sales taxes on a net basis. The FASB decided to provide similar transition relief to that provided in IFRS 15 for contract modifications. However, with respect to completed contracts, the FASB decided to (a) amend the definition of a completed contract; and (b) provide transition relief, similar to the relief provided by the IASB, only for entities that apply Topic 606 in accordance with paragraph 606-10-65-1(d)(2) (equivalent to paragraph C3(b) of IFRS 15).

BC27H Because of the different decisions of the boards, Appendix A *Comparison of IFRS 15 and Topic 606* to this Basis for Conclusions has been updated. The IASB's considerations together with an overview of the FASB's considerations (based on both the amendments to Topic 606 issued and decisions made by the FASB until March 2016) in reaching their respective decisions are explained in the following paragraphs.

Topics for which both the IASB and FASB decided to amend IFRS 15 and Topic 606

Topic	Reference
Identifying performance obligations	paragraphs BC116A–BC116U
Principal versus agent considerations	paragraphs BC385A–BC385Z
Licensing	paragraphs BC414A–BC414Y paragraphs BC421A–BC421J
Practical expedients on transition	paragraphs BC445A–BC445B paragraphs BC445J–BC445R

Topics for which the IASB decided not to amend IFRS 15 but the FASB decided to amend Topic 606

Topic	Reference
Collectability	paragraphs BC46A–BC46H
Presentation of sales taxes (determining the transaction price)	paragraphs BC188A–BC188D
Non-cash consideration	paragraphs BC254A–BC254H
Definition of a completed contract	paragraphs BC445C–BC445I

Scope

BC28 The boards decided that IFRS 15 should apply only to a subset of revenue as defined in each of the boards' conceptual frameworks (ie revenue from contracts with customers). Revenue from transactions or events that does not arise from a contract with a customer is not within the scope of IFRS 15 and, therefore, those transactions or events will continue to be recognised in accordance with other Standards, for example:

- (a) dividends received (although these requirements existed in previous revenue Standards in IFRS, the IASB has moved them unchanged, and without changing their effect, into IFRS 9 *Financial Instruments*);
- (b) non-exchange transactions (for example, donations or contributions received);

- (c) for IFRS, changes in the value of biological assets, investment properties and the inventory of commodity broker-traders; and
- (d) for US GAAP, changes in regulatory assets and liabilities arising from alternative revenue programmes for rate-regulated entities in the scope of Topic 980 on regulated operations. (The FASB decided that the revenue arising from those assets or liabilities should be presented separately from revenue arising from contracts with customers. Therefore, the FASB made amendments to Subtopic 980-605 *Regulated Operations—Revenue Recognition*.)

BC29 The boards decided not to amend the existing definitions of revenue in each of their conceptual frameworks. The boards decided that they will consider the definition of revenue when they revise their respective conceptual frameworks. However, the IASB decided to carry forward into IFRS 15 the description of revenue from the IASB's *Conceptual Framework for Financial Reporting* rather than the definition of revenue from a previous revenue Standard. The IASB noted that the definition in a previous revenue Standard referred to 'gross inflow of economic benefits' and it had concerns that some might have misread that reference as implying that an entity should recognise as revenue a prepayment from a customer for goods or services. As described in paragraphs BC17–BC24, the principle is that revenue is recognised in accordance with IFRS 15 as a result of an entity satisfying a performance obligation in a contract with a customer. In addition, the FASB decided to carry forward a definition of revenue that is based on the definition in FASB Concepts Statement No. 6 *Elements of Financial Statements*.

BC30 The converged definitions of a contract and a customer establish the scope of IFRS 15.

Definition of a contract (Appendix A)

BC31 The boards' definition of contract is based on common legal definitions of a contract in the United States and is similar to the definition of a contract used in IAS 32 *Financial Instruments: Presentation*. The IASB decided not to adopt a single definition of a contract for both IAS 32 and IFRS 15, because the IAS 32 definition implies that contracts can include agreements that are not enforceable by law. Including such agreements would have been inconsistent with the boards' decision that a contract with a customer must be enforceable by law for an entity to recognise the rights and obligations arising from that contract. The IASB also noted that amending the IAS 32 definition would have posed the risk of unintended consequences in accounting for financial instruments.

BC32 The definition of a contract emphasises that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. The boards noted that the agreement does not need to be in writing to be a contract. Whether the agreed-upon terms are written, oral or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework (or equivalent framework) that exists to ensure that the parties' rights and obligations are upheld. The boards observed that the factors that determine enforceability may differ between jurisdictions. Although there must be enforceable rights and obligations between parties for a contract to exist, the boards decided that the performance obligations within the contract could include promises that result in the customer having a valid expectation that the entity will transfer goods or services to the customer even though those promises are not enforceable (see paragraph BC87).

BC33 The boards decided to complement the definition of a contract by specifying criteria that must be met before an entity can apply the revenue recognition model to that contract (see paragraph 9 of IFRS 15). Those criteria are derived mainly from previous revenue recognition requirements and other existing standards. The boards decided that when some or all of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations. The boards' rationale for including those criteria is discussed in paragraphs BC35–BC46.

BC34 The boards also decided that those criteria would be assessed at contract inception and would not be reassessed unless there is an indication that there has been a significant change in facts and circumstances (see paragraph 13 of IFRS 15). The boards decided that it was important to reassess the criteria in those cases, because that change might clearly indicate that the remaining

contractual rights and obligations are no longer enforceable. The word ‘remaining’ in paragraph 13 of IFRS 15 indicates that the criteria would be applied only to those rights and obligations that have not yet transferred. That is, an entity would not include in the reassessment (and therefore would not reverse) any receivables, revenue or contract assets already recognised.

The parties have approved the contract and are committed to perform their respective obligations (paragraph 9(a))

- BC35 The boards decided to include this criterion because if the parties to a contract have not approved the contract, it is questionable whether that contract is enforceable. Some respondents questioned whether oral and implied contracts could meet this criterion, especially if it is difficult to verify an entity’s approval of that contract. The boards noted that the form of the contract does not, in and of itself, determine whether the parties have approved the contract. Instead, an entity should consider all relevant facts and circumstances in assessing whether the parties intend to be bound by the terms and conditions of the contract. Consequently, in some cases, the parties to an oral or an implied contract (in accordance with customary business practices) may have agreed to fulfil their respective obligations. In other cases, a written contract may be required to determine that the parties to the contract have approved it.
- BC36 In addition, the boards decided that the parties should be committed to performing their respective obligations under the contract. However, the boards decided that an entity and a customer would not always need to be committed to fulfilling all of their respective rights and obligations for a contract to meet the requirements in paragraph 9(a) of IFRS 15. For example, a contract might include a requirement for the customer to purchase a minimum quantity of goods from the entity each month, but the customer’s past practice indicates that the customer is not committed to always purchasing the minimum quantity each month and the entity does not enforce the requirement to purchase the minimum quantity. In that example, the criterion in paragraph 9(a) of IFRS 15 could still be satisfied if there is evidence that demonstrates that the customer and the entity are substantially committed to the contract. The boards noted that requiring all of the rights and obligations to be fulfilled would have inappropriately resulted in no recognition of revenue for some contracts in which the parties are substantially committed to the contract.

The entity can identify each party’s rights regarding the goods or services to be transferred (paragraph 9(b))

- BC37 The boards decided to include this criterion because an entity would not be able to assess the transfer of goods or services if it could not identify each party’s rights regarding those goods or services.

The entity can identify the payment terms for the goods or services to be transferred (paragraph 9(c))

- BC38 The boards decided to include this criterion because an entity would not be able to determine the transaction price if it could not identify the payment terms in exchange for the promised goods or services.
- BC39 Respondents from the construction industry questioned whether an entity can identify the payment terms for orders for which the scope of work may already have been defined even though the specific amount of consideration for that work has not yet been determined and may not be finally determined for a period of time (sometimes referred to as unpriced change orders or claims). The boards clarified that their intention is not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and the entity expects that the price will be approved. The boards noted that, in those cases, the entity would consider the requirements for contract modifications (see paragraphs BC76–BC83).

The contract has commercial substance (paragraph 9(d))

- BC40 The boards decided to include ‘commercial substance’ as a criterion when they discussed whether revenue should be recognised in contracts with customers that include non-monetary exchanges. Without that requirement, entities might transfer goods or services back and forth to each other (often for little or no cash consideration) to artificially inflate their revenue. Consequently, the

boards decided that an entity should not recognise revenue from a non-monetary exchange if the exchange has no commercial substance.

- BC41 The boards decided to describe commercial substance in paragraph 9(d) of IFRS 15 in a manner that is consistent with its existing meaning in other financial reporting contexts, such as existing requirements for non-monetary exchange transactions. The boards also observed that this criterion is important in all contracts (not only non-monetary exchanges) because without commercial substance it is questionable whether an entity has entered into a transaction that has economic consequences. Consequently, the boards decided that all contracts should have commercial substance before an entity can apply the other requirements in the revenue recognition model.

It is probable that the entity will collect the consideration to which it will be entitled (paragraph 9(e))

- BC42 The boards included the criterion in paragraph 9(e) of IFRS 15 (which acts like a collectability threshold) because they concluded that the assessment of a customer's credit risk was an important part of determining whether a contract is valid. Furthermore, the boards decided to include this criterion as a consequence of their decision that customer credit risk should not affect the measurement or presentation of revenue (see paragraphs BC259–BC265).
- BC43 The boards decided that a collectability threshold is an extension of the other requirements in paragraph 9 of IFRS 15 on identifying the contract. In essence, the other criteria in paragraph 9 require an entity to assess whether the contract is valid and represents a genuine transaction. The collectability threshold is related to that assessment because a key part of assessing whether a transaction is valid is determining the extent to which the customer has the ability and the intention to pay the promised consideration. In addition, entities generally only enter into contracts in which it is probable that the entity will collect the amount to which it will be entitled.
- BC44 The boards noted that the term 'probable' has different meanings under US GAAP and IFRS. Under US GAAP, the term was initially defined in Topic 450 *Contingencies* as 'likely to occur' whereas under IFRS, probable is defined as 'more likely than not'. The boards noted that using the same term which has different meanings in US GAAP and IFRS could result in accounting that is not converged when determining whether the criterion in paragraph 9(e) of IFRS 15 is met. However, the boards noted that the term 'probable' was used in some of the collectability thresholds in their previous revenue recognition requirements and both boards wanted to maintain consistency with those requirements. (The term 'reasonably assured' was also used in collectability thresholds in some parts of US GAAP. However, in this context, the FASB understood that in practice, probable and reasonably assured had similar meanings.) In addition, the boards observed that in most transactions, an entity would not enter into a contract with a customer in which there was significant credit risk associated with that customer without also having adequate economic protection to ensure that it would collect the consideration. Consequently, the boards decided that there would not be a significant practical effect of the different meaning of the same term because the population of transactions that would fail to meet the criterion in paragraph 9(e) of IFRS 15 would be small.
- BC45 In determining whether it is probable that an entity will collect the amount of consideration to which the entity will be entitled, an entity might first need to determine the amount of consideration to which the entity will be entitled. This is because, in some circumstances, the amount of consideration to which an entity will be entitled may be less than the price stated in the contract. This could be because the entity might offer the customer a price concession (see paragraph 52 of IFRS 15) or because the amount of consideration to which an entity will be entitled varies for other reasons, such as the promise of a bonus. In either of those circumstances, an entity considers whether it is probable that the entity will collect the amount of consideration to which it will be entitled when the uncertainty relating to that consideration is resolved. The entity assesses whether it is probable of collecting that amount by considering both of the following:
- (a) the ability (ie the financial capacity) of the customer to pay the amount of consideration to which the entity will be entitled in exchange for the goods or services transferred.
 - (b) the customer's intention to pay that amount. The boards observed that an assessment of the customer's intention would require an entity to consider all of the facts and

circumstances, including the past practice of that customer or customer class. The boards noted that this assessment should be made on the assumption that the amount will be due (ie the corresponding performance obligation will be satisfied and the consideration is not subject to further variability that might affect the entity's entitlement to that consideration).

- BC46 In addition, the boards specified in paragraph 9(e) of IFRS 15 that an entity should assess only the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer. Therefore, if the customer were to fail to perform as promised and consequently the entity would respond to the customer's actions by not transferring any further goods or services to the customer, the entity would not consider the likelihood of payment for those goods or services that would not be transferred.

Clarifications to IFRS 15 (amendments issued in April 2016)—topics for which the IASB decided not to amend IFRS 15

- BC46A The TRG discussed an implementation question raised by stakeholders about how to apply the collectability criterion in paragraph 9(e) of IFRS 15 in instances in which the entity has received non-refundable consideration from a customer assessed as having poor credit quality. The discussion informed the boards that there are potentially different interpretations of:
- (a) how to apply the collectability criterion in paragraph 9(e) when it is not probable that the total consideration promised in the contract is collectable; and
 - (b) when to recognise the non-refundable consideration received from the customer as revenue in accordance with paragraph 15 of IFRS 15 when the contract does not meet the criteria in paragraph 9 of IFRS 15.

Assessing collectability

- BC46B Paragraph 9(e) requires an entity to assess whether it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This assessment forms part of Step 1 of IFRS 15 *Identify the contract(s) with a customer*. The TRG's discussions informed the boards that some stakeholders interpreted this requirement to mean that an entity should assess the probability of collecting all of the consideration promised in the contract. Under this interpretation, some contracts with customers that are assessed as having poor credit quality would not meet the criteria in paragraph 9(e), even though they are otherwise valid contracts. Other stakeholders asserted that those contracts would be valid if the entity has the ability to protect itself from credit risk.
- BC46C The boards noted that the assessment in paragraph 9(e) requires an entity to consider how the entity's contractual rights to the consideration relate to its performance obligations. That assessment considers the entity's exposure to the customer's credit risk and the business practices available to the entity to manage its exposure to credit risk throughout the contract. For example, an entity may be able to stop providing goods or services to the customer or require advance payments. This is consistent with the explanation of the boards' considerations as described in paragraph BC46.
- BC46D The FASB decided to amend the implementation guidance and illustrations in Topic 606 to clarify that an entity should assess the collectability of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectability of the consideration promised in the contract for all of the promised goods or services.
- BC46E Having considered the wider implications of amending IFRS 15 before its effective date, the IASB concluded that the existing requirements in IFRS 15 and the explanations in paragraphs BC42–BC46 are sufficient. The IASB noted that it expects practice to develop consistently with the boards' intentions in developing the collectability criterion in paragraph 9(e). The IASB does not expect the FASB's anticipated clarifications to the paragraph equivalent to paragraph 9(e) in Topic 606 to result in any additional differences in outcomes. In reaching its decision, the IASB observed that an entity will generally not enter into a contract with a customer if the entity does not consider it to be probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This is consistent with the boards'

reasoning in paragraph BC43. It was not the boards' intention that many contracts should fail the condition in paragraph 9(e). On this basis, the IASB thinks that the population of contracts to which any clarification to paragraph 9(e) might apply is small.

Contract termination

- BC46F Paragraph 15 specifies when an entity should recognise any consideration received from a customer as revenue when the contract does not meet Step 1 of the revenue recognition model. Paragraph 15(b) states that an entity should recognise revenue when the contract has been terminated and the consideration received from the customer is non-refundable. The TRG's discussions informed the boards about potential diversity in stakeholders' understanding of when a contract is terminated. The assessment of when a contract is terminated affects when an entity recognises revenue in a contract that does not meet Step 1 of the revenue recognition model. Some stakeholders asserted that a contract is terminated when an entity stops transferring promised goods or services to the customer. Other stakeholders asserted that a contract is terminated only when the entity stops pursuing collection from the customer. Stakeholders noted that those two events often occur at different points in time. For example, entities sometimes pursue collection for a significant period of time after they have stopped transferring promised goods or services to the customer. As a result, non-refundable consideration received from the customer might be recognised as a liability for a significant period of time during which an entity pursues collection, even though the entity may have stopped transferring promised goods or services to the customer and has no further obligations to transfer goods or services to the customer.
- BC46G The FASB decided to amend paragraph 606-10-25-7 of Topic 606 (equivalent to paragraph 15 of IFRS 15) to add an additional event in which an entity should recognise any consideration received as revenue. This amendment is expected to allow an entity to recognise any consideration received as revenue when (a) the entity has transferred control of the goods or services to which the consideration received relates; (b) the entity has stopped transferring additional goods or services and has no obligation to transfer additional goods or services; and (c) the consideration received from the customer is non-refundable.
- BC46H The IASB noted that contracts often specify that an entity has the right to terminate the contract in the event of non-payment by the customer and that this would not generally affect the entity's rights to recover any amounts owed by the customer. The IASB also noted that an entity's decision to stop pursuing collection would not typically affect the entity's rights and the customer's obligations under the contract with respect to the consideration owed by the customer. On this basis, the IASB concluded that the existing requirements in IFRS 15 are sufficient for an entity to conclude, without any additional clarification, that a contract is terminated when it stops providing goods or services to the customer. Some IASB members also expressed concerns about the potential for unintended consequences relating to other areas of IFRS if contract termination were to be defined in IFRS 15. Consequently, the IASB decided not to amend paragraph 15.

Accounting for contracts that do not meet the criteria in paragraph 9

- BC47 The boards decided to include the requirements in paragraphs 14–16 of IFRS 15 in response to questions from some respondents about how an entity should account for its rights and obligations when a contract does not meet the criteria in paragraph 9 of IFRS 15. Those respondents were concerned that if a contract did not meet the criteria in paragraph 9 of IFRS 15, in the absence of specific requirements, an entity would seek alternative guidance and potentially apply the revenue recognition model by analogy, which might not result in appropriate accounting. Consequently, the boards specified that in cases in which the contract does not meet the criteria in paragraph 9 of IFRS 15, an entity should recognise the consideration received as revenue only when one of the events in paragraph 15 of IFRS 15 has occurred or the entity reassesses the criteria in paragraph 9 of IFRS 15 and the contract subsequently meets those criteria.
- BC48 The requirements in paragraph 15 are consistent with the boards' rationale for paragraph 9 of IFRS 15, which is to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognising revenue for those contracts would not provide a faithful representation of such transactions. The requirements therefore preclude an entity from recognising any revenue until the contract is either complete or cancelled or until a subsequent

reassessment indicates that the contract meets all of the criteria in paragraph 9 of IFRS 15. The boards noted that this approach is similar to the ‘deposit method’ that was previously included in US GAAP and that was applied when there was no consummation of a sale.

- BC49 The boards considered whether to include asset derecognition requirements (and therefore cost recognition requirements) for assets related to a contract that does not meet the criteria in paragraph 9 of IFRS 15. However, the boards decided not to include requirements for asset derecognition for these types of transactions, because including those requirements would be outside the scope of this project. (However, the FASB added some asset derecognition guidance to other Standards for transactions outside the scope of the requirements—that is, for the transfer of non-financial assets. See paragraphs BC494–BC503.) The boards noted that entities should apply existing IFRS and US GAAP to assets related to contracts that do not meet the criteria in paragraph 9 of IFRS 15.

Wholly unperformed contracts

- BC50 The boards decided that IFRS 15 should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity’s financial position or performance until either party performs. In contrast, there could be an effect on an entity’s financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.
- BC51 In accordance with IFRS 15, an entity’s rights and obligations in wholly unperformed non-cancellable contracts are measured at the same amount and, therefore, would offset each other at inception. However, by including those contracts within the scope of IFRS 15, an entity would provide additional information about a change in its financial position that resulted from entering into those contracts, that is, disclosing the amount of transaction price allocated to the remaining performance obligations in that wholly unperformed contract (see paragraph 120 of IFRS 15).

Definition of a customer (paragraph 6 and Appendix A)

- BC52 The boards decided to define the term ‘customer’ to enable an entity to distinguish contracts that should be accounted for under IFRS 15 (ie contracts with customers) from contracts that should be accounted for under other requirements.
- BC53 The definition of a customer in IFRS 15 refers to an entity’s ordinary activities. Some respondents asked the boards to clarify the meaning of ordinary activities; however, the boards decided not to provide additional requirements, because the notion of ordinary activities is derived from the definitions of revenue in the boards’ respective conceptual frameworks. In particular, the IASB’s *Conceptual Framework* description of revenue refers specifically to the ‘ordinary activities of an entity’ and the definition of revenue in FASB Concepts Statement No. 6 refers to the notion of an entity’s ‘ongoing major or central operations’. As noted in paragraph BC29, the boards did not reconsider those definitions as part of the Revenue Recognition project.
- BC54 Some respondents asked the boards to clarify whether the parties to some common types of contracts (for example, contracts with collaborators or partners) would meet the definition of a customer. However, the boards decided that it would not be feasible to develop application guidance that would apply uniformly to various industries because the nature of the relationship (ie supplier-customer versus collaboration or partnership) would depend on specific terms and conditions in those contracts. The boards observed that in many arrangements highlighted by respondents, an entity would need to consider all relevant facts and circumstances, such as the purpose of the activities undertaken by the counterparty, to determine whether the counterparty is a customer. Examples of arrangements in which an entity would need to make that assessment are as follows:

- (a) collaborative research and development efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defence, technology and healthcare industries or in higher education;
 - (b) arrangements in the oil and gas industry in which partners in an offshore oil and gas field may make payments to each other to settle any differences between their proportionate entitlements to production volumes from the field during a reporting period; and
 - (c) arrangements in the not-for-profit industry in which an entity receives grants and sponsorship for research activity and the grantor or sponsor may specify how any output from the research activity will be used.
- BC55 The boards noted that a contract with a collaborator or a partner (for example, a joint arrangement as defined in IFRS 11 *Joint Arrangements* or a collaborative arrangement within the scope of Topic 808 *Collaborative Arrangements*) could also be within the scope of IFRS 15 if that collaborator or partner meets the definition of a customer for some or all of the terms of the arrangement.
- BC56 The boards also noted that in some cases it might be appropriate for an entity to apply the principles of IFRS 15 to some transactions with collaborators or partners. For example, an entity might consider applying IFRS 15 to a collaborative arrangement or partnership, provided such application is appropriate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* or, for an entity applying US GAAP, provided there are not more relevant authoritative requirements in US GAAP.
- BC57 Notwithstanding the boards' decision that only contracts with customers should be accounted for under IFRS 15, the boards also decided that some of the requirements in IFRS 15 should apply to the transfer of non-financial assets that are not an output of an entity's ordinary activities (see paragraphs BC494–BC503).

Exchanges of products to facilitate a sale to another party (paragraph 5(d))

- BC58 In industries with homogeneous products, it is common for entities in the same line of business to exchange products to facilitate sales to customers or potential customers other than the parties to the exchange. For example, an oil supplier may swap inventory with another oil supplier to reduce transport costs, meet immediate inventory needs, or otherwise facilitate the sale of oil to the end customer. The boards noted that the party exchanging inventory with the entity meets the definition of a customer, because it has contracted with the entity to obtain an output of the entity's ordinary activities. Consequently, in the absence of specific requirements, an entity might recognise revenue once for the exchange of inventory and then again for the sale of the inventory to the end customer. The boards decided that this outcome would be inappropriate for the following reasons:
- (a) it would have grossed up revenues and expenses and made it difficult for users of financial statements to assess the entity's performance and gross margins during the reporting period; and
 - (b) some view the counterparty in those arrangements as also acting as a supplier and not as a customer.
- BC59 The boards considered modifying the definition of a customer. However, they rejected that alternative because of concerns about unintended consequences. Consequently, the boards decided to exclude from the scope of IFRS 15 transactions involving non-monetary exchanges between entities in the same line of business to facilitate sales to customers or to potential customers. The FASB noted such exchanges should remain within the scope of Topic 845 on non-monetary transactions.

Contracts with customers outside the scope of the requirements (paragraph 5)

- BC60 The boards also excluded from the scope of IFRS 15 three types of contracts with customers that they are addressing in other Standards:

- (a) leases;
- (b) insurance contracts; and
- (c) financial instruments and other contractual rights or obligations within the scope of the boards' other Standards.

- BC61 Some respondents asked the FASB to clarify what is meant by 'contractual rights or obligations' in paragraph 5 of the requirements, because those respondents stated that it is unclear whether financial instrument arrangements that are addressed elsewhere in the Codification, such as letters of credit and loan commitments (addressed in Topic 440 *Commitments*), would be included within the scope of Topic 606. The FASB noted that its intention is that if specific requirements in other Topics of the Codification deal with a transaction, the more detailed requirements from those other Topics should be applied rather than the requirements in Topic 606. For example, the FASB decided to exclude from the scope of Topic 606 guarantees (other than product warranties) that are within the scope of Topic 460 *Guarantees*, because the focus of the existing accounting requirements for those guarantee arrangements relates primarily to recognising and measuring a guarantee liability.
- BC62 Some respondents reasoned that excluding some contracts with customers from the scope of IFRS 15 (such as those identified in paragraph BC60) could perpetuate the development of industry-specific or transaction-specific revenue recognition guidance, which would be inconsistent with the Revenue Recognition project's stated objective. The boards disagreed with that view. In the boards' view, IFRS 15 provides them with a framework for considering revenue issues in other standard-setting projects. The boards decided that, within the context of those other projects, a different basis of accounting for those contracts with customers might provide users of financial statements with more relevant information.
- BC63 Other respondents identified what they perceived to be a contradiction within the scope requirements in IFRS 15 and IFRS 9. Those respondents stated that some of the requirements for accounting for contract assets (which would meet the definition of a financial asset) are inconsistent with the requirements in financial instruments Standards for accounting for financial assets. For example, in some cases a contract asset is not required to be adjusted for the time value of money (see paragraph BC236), and in other cases the contract asset might initially be measured at an amount that excludes some of the expected cash flows if the transaction price includes variable consideration (see paragraphs BC189–BC223). However, the IASB disagreed with those respondents. The IASB noted that the requirements in paragraph 5 of IFRS 15 (together with paragraph 2(k) of IAS 39 *Financial Instruments: Recognition and Measurement*, which is a consequential amendment to IAS 39 added by IFRS 15) are clear that when a contract asset is within the scope of IFRS 15, it is not within the scope of IFRS 9.

Contracts partially within the scope of other Standards (paragraph 7)

- BC64 Some contracts with customers are partially within the scope of IFRS 15 and partially within the scope of other Standards (for example, a lease with a service contract). The boards decided that it would be inappropriate in those cases for an entity to account for the entire contract in accordance with one standard or another. This is because it could result in different accounting outcomes depending on whether the goods or services were sold on a stand-alone basis or together with other goods or services.
- BC65 The boards considered whether the requirements in IFRS 15 should be the default approach for separating a contract and allocating consideration to each part. However, specific issues could arise in separating contracts that are not within the scope of IFRS 15. For example, a financial instrument or an insurance contract might require an entity to provide services that are best accounted for in accordance with IFRS 9, Subtopic 942-605 *Financial Services—Depository and Lending—Revenue Recognition*, IFRS 4 *Insurance Contracts*, or Subtopic 944-605 *Financial Services—Insurance—Revenue Recognition*.
- BC66 Consequently, the boards decided that if other Standards specify how to separate and/or initially measure parts of a contract, an entity should first apply those Standards. In other words, the more specific Standard would take precedence in accounting for a part of a contract and any residual

consideration should be allocated to the part(s) of the contract within the scope of IFRS 15. This rationale is consistent with the principle in IFRS 15 related to scope, which is that another Standard should be applied to a portion of the contract or arrangement if that Standard provides specific requirements for that portion of the contract or arrangement. The boards' decision is also consistent with the requirements for multiple-element arrangements in US GAAP that were replaced by Topic 606. The boards noted that this decision results in any discount in the overall arrangement being allocated to the portion of the arrangement within the scope of IFRS 15.

Identifying the contract (paragraphs 9–16)

- BC67 The boards decided that the revenue recognition model would apply to a contract with a customer only when the criteria in paragraph 9 of IFRS 15 are met. The rationale for those criteria is described in paragraphs BC33–BC46.
- BC68 IFRS 15 applies to a single contract with a customer. In many cases, the contract that is accounted for separately will be the individual contract negotiated with the customer. However, the structure and scope of a contract can vary depending on how the parties to the contract decide to record their agreement. For instance, there may be legal or commercial reasons for the parties to use more than one contract to document the sale of related goods or services or to use a single contract to document the sale of unrelated goods or services. One of the boards' objectives in developing IFRS 15 is that the accounting for a contract should depend on an entity's present rights and obligations rather than on how the entity structures the contract.

Applying IFRS 15 at a portfolio level

- BC69 IFRS 15 specifies the accounting required for an individual contract. Many entities have a large number of contracts and as a result some respondents noted practical challenges in applying the model on a contract-by-contract basis. These respondents questioned whether it would always be necessary to apply IFRS 15 on a contract-by-contract basis. The boards observed that the way in which an entity applies the model to its contracts is not a matter for which the boards should specify requirements. Nonetheless, in the light of the feedback, the boards decided to include a practical expedient in paragraph 4 of IFRS 15 to acknowledge that a practical way to apply IFRS 15 to some contracts may be to use a 'portfolio approach'. The boards acknowledged that an entity would need to apply judgement in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio. In their discussions, the boards indicated that they did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.
- BC70 The boards observed that because it is a practical way to apply IFRS 15, the portfolio approach may be particularly useful in some industries in which an entity has a large number of similar contracts and applying the model separately for each contract may be impractical. For example, entities in the telecommunications industry explained that implementing accounting systems to determine the stand-alone selling price for the promised goods or services in each contract and, in turn, allocating the transaction price to the performance obligations identified in that contract would be complex and costly (see paragraphs BC287–BC293).

Combination of contracts (paragraph 17)

- BC71 The boards decided to include requirements in paragraph 17 of IFRS 15 for when an entity should combine two or more contracts and account for them as a single contract. This is because, in some cases, the amount and timing of revenue might differ depending on whether an entity accounts for two or more contracts separately or accounts for them as one contract.
- BC72 The boards decided that entering into contracts at or near the same time is a necessary condition for the contracts to be combined. That decision is consistent with the objective of identifying the contract that is to be accounted for as the unit of account because that assessment is also performed at contract inception.

- BC73 The boards decided that in addition to entering into contracts at or near the same time, the contracts should satisfy one or more of the criteria in paragraph 17 of IFRS 15 for the contracts to be combined. The boards observed that when either criterion (a) or (b) in paragraph 17 of IFRS 15 is met, the relationship between the consideration in the contracts (ie the price interdependence) is such that if those contracts were not combined, the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer. The boards decided to include the criterion in paragraph 17(c) of IFRS 15 to avoid the possibility that an entity could effectively bypass the requirements for identifying performance obligations depending on how the entity structures its contracts.
- BC74 The boards clarified that for two or more contracts to be combined, they should be with the same customer. However, the boards acknowledged that in some situations, contracts with related parties (as defined in IAS 24 *Related Party Disclosures* and Topic 850 *Related Party Disclosures*) should be combined if there are interdependencies between the separate contracts with those related parties. Thus, in those situations, combining the contracts with related parties results in a more appropriate depiction of the amount and timing of revenue recognition.
- BC75 The boards also considered whether to specify that all contracts should be combined if they were negotiated as a package to achieve a single commercial objective, regardless of whether those contracts were entered into at or near the same time with the same customer. However, the boards decided not to do this, primarily because they were concerned that doing so could have had the unintended consequence of an entity combining too many contracts and not faithfully depicting the entity's performance. Furthermore, the boards decided that an entity should apply judgement to determine whether a contract is entered into 'at or near the same time'. However, the boards noted that the longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

Contract modifications (paragraphs 18–21)

- BC76 The boards observed that previous revenue recognition requirements did not include a general framework for accounting for contract modifications. Therefore, the boards decided to include requirements regarding contract modifications in IFRS 15 to improve consistency in the accounting for contract modifications. As the revenue recognition model developed, the boards proposed different approaches to account for contract modifications. However, each approach was developed with the overall objective of faithfully depicting an entity's rights and obligations in the modified contract. The boards concluded that to faithfully depict the rights and obligations arising from a modified contract, an entity should account for some modifications prospectively and for other modifications on a cumulative catch-up basis.
- BC77 The boards decided that a contract modification should be accounted for prospectively if the additional promised goods or services are distinct and the pricing for those goods or services reflects their stand-alone selling price (see paragraph 20 of IFRS 15). The boards decided that when those criteria are met, there is no economic difference between an entity entering into a separate contract for the additional goods or services and an entity modifying an existing contract.
- BC78 The boards also decided that a contract modification should be accounted for prospectively when the goods or services to be provided after the modification are distinct from the goods or services already provided (see paragraph 21(a) of IFRS 15). The boards decided that this should be the case regardless of whether the pricing of the additional promised goods or services reflected their stand-alone selling prices. This is because accounting for those types of modifications on a cumulative catch-up basis could be complex and may not necessarily faithfully depict the economics of the modification, because the modification is negotiated after the original contract and is based on new facts and circumstances. Therefore, this approach avoids opening up the accounting for previously satisfied performance obligations and, thus, avoids any adjustments to revenue for satisfied performance obligations.
- BC79 Some respondents were concerned that an entity would also be required to use a cumulative catch-up basis to account for modifications to a contract with a single performance obligation that is made up of a series of distinct goods or services. Those contracts typically include repetitive services, such as energy contracts or mobile phone airtime services. The boards considered those concerns and clarified in paragraph 21(a) of IFRS 15 that the determination of whether a modification is accounted for prospectively depends on whether the remaining promises in the

contract are for distinct goods or services. This is the case even if an entity determines that it has a single performance obligation, provided that the performance obligation represents a series of distinct goods or services (see paragraphs BC113–BC116).

- BC80 The boards decided that if the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied (ie a performance obligation satisfied over time), an entity should recognise the effect of the modification on a cumulative catch-up basis. This requires an entity to update the transaction price and the measure of progress towards complete satisfaction of a performance obligation, both of which may change as a result of the contract modification. That approach is particularly relevant to, and generally accepted in, the construction industry because a modification to those types of contracts would typically not result in the transfer of additional goods or services that are distinct from those promised in the existing contract.
- BC81 Respondents also asked how the requirements for contract modifications would apply to unpriced change orders (see paragraph BC39) and contract claims (ie specific modifications in which the changes in scope and price are unapproved or in dispute). IFRS and US GAAP previously included specific guidance for unpriced change orders and contract claims within construction-type and production-type contracts. The boards decided that it was unnecessary to provide specific requirements for the accounting for these types of modifications because IFRS 15 includes the relevant requirements, specifically:
- (a) paragraphs 18 and 19 of IFRS 15 require an entity to determine whether the rights and obligations of the parties to the contract that are created or changed by the unpriced change order or contract claim are enforceable;
 - (b) paragraph 19 of IFRS 15 requires an entity to estimate the change to the transaction price for the unpriced change order or contract claim; and
 - (c) paragraph 21 of IFRS 15 requires an entity to determine whether the unpriced change order or contract claim should be accounted for on a prospective basis or a cumulative catch-up basis.

Interaction between changes in the transaction price and contract modifications

- BC82 The 2011 Exposure Draft proposed that an entity would account for contract modifications that result only in a change in the contract price on a cumulative catch-up basis because this would be consistent with the requirements for changes in the transaction price (as a result of changes in the estimate of variable consideration). In their redeliberations, the boards noted that the proposal would result in very different accounting outcomes depending on whether a distinct good or service was included in the modification. This is because modifications that change only the price would be accounted for on a cumulative catch-up basis, whereas modifications in which a distinct good or service (no matter how small) is added to the contract at the same time as a price change would be accounted for on a prospective basis. Furthermore, the boards noted that changes in the transaction price arising from a contract modification and changes in the expectations of variable consideration are the result of different economic events—a change in the expectation of variable consideration arises from a change in a variable that was identified and agreed upon at contract inception, whereas a change in price arising from a contract modification arises from a separate and subsequent negotiation between the parties to the contract. Consequently, the boards decided that a contract modification resulting only in a change in the contract price should be accounted for in a manner that is consistent with other contract modifications.
- BC83 Some respondents requested that the boards clarify how an entity should allocate a change in the transaction price that occurs after a modification of the contract (that is accounted for in accordance with paragraph 21(a) of IFRS 15) but the change in the transaction price is attributable to an amount of variable consideration promised before the modification. This may occur because the estimate of the amount of variable consideration in the initial contract has changed or is no longer constrained. Specifically, those respondents asked whether, in those circumstances, an entity should allocate the corresponding change in the transaction price to the performance obligations in the modified contract, or to the performance obligations identified in the contract before the modification (ie the initial contract), including to performance obligations that were satisfied before the modification. In response to that feedback, the boards clarified in paragraph 90

of IFRS 15 that the allocation of the change in transaction price in those circumstances depends on whether, and the extent to which, the change in the transaction price is attributable to an amount of variable consideration promised before the modification. In providing that clarification, the boards noted that it would be appropriate in those circumstances to allocate a change in the transaction price to the performance obligations identified in the initial contract, if the promised variable consideration and the resolution of the uncertainty associated with that amount of variable consideration are not affected by the contract modification.

Identifying performance obligations

Definition of a performance obligation (Appendix A)

- BC84 IFRS 15 distinguishes between obligations to provide goods or services to a customer and other obligations by defining those obligations to provide goods or services as performance obligations. The notion of a performance obligation is similar to the notions of deliverables, components or elements of a contract in previous revenue Standards. Although the notion of a performance obligation is implicit in previous revenue Standards, the term 'performance obligation' has not been defined previously.
- BC85 The boards' objective in developing the definition of a performance obligation was to ensure that entities appropriately identify the unit of account for the goods and services promised in a contract with a customer. The boards decided that because the revenue recognition model is an allocated transaction price model, identifying a meaningful unit of account that depicts the goods and services in the contract is fundamental for the purpose of recognising revenue on a basis that faithfully depicts the entity's performance in transferring the promised goods or services to the customer.
- BC86 The boards decided that a performance obligation could be either of the following:
- (a) a good or service (or a bundle of goods or services) that is distinct (see paragraphs BC94–BC112); or
 - (b) a series of distinct goods or services that are substantially the same and have the same pattern of transfer (see paragraphs BC113–BC116).

Identifying the promised goods or services (paragraphs 24–25)

- BC87 Before an entity can identify its performance obligations in a contract with a customer, the entity would first need to identify all of the promised goods or services in that contract. The boards noted that in many cases, all of the promised goods or services in a contract might be identified explicitly in that contract. However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices. The boards decided that such implied promises should be considered when determining the entity's performance obligations, if those practices create a valid expectation of the customer that the entity will transfer a good or service (for example, some when-and-if-available software upgrades). The boards also noted that the implied promises in the contract do not need to be enforceable by law. If the customer has a valid expectation, then the customer would view those promises as part of the negotiated exchange (ie goods or services that the customer expects to receive and for which it has paid). The boards noted that in the absence of these requirements developed by the boards, an entity might recognise all of the consideration in a contract as revenue even though the entity continues to have remaining (implicit) promises related to the contract with the customer.
- BC88 Some respondents suggested that some promised goods or services should be excluded from the scope of IFRS 15 and accounted for as marketing expenses or incidental obligations, even though those promises would meet the definition of a performance obligation. Examples of such promised goods or services may include 'free' handsets provided by telecommunication entities, 'free' maintenance provided by automotive manufacturers and customer loyalty points awarded by supermarkets, airlines and hotels. Those respondents stated that revenue should be recognised only for the main goods or services for which the customer has contracted and not for what they consider to be marketing incentives and other incidental obligations.

- BC89 The boards observed that when a customer contracts with an entity for a bundle of goods or services, it can be difficult and subjective for the entity to identify the main goods or services for which the customer has contracted. In addition, the outcome of that assessment could vary significantly depending on whether the entity performs the assessment from the perspective of its business model or from the perspective of the customer. Consequently, the boards decided that all goods or services promised to a customer as a result of a contract give rise to performance obligations because those promises were made as part of the negotiated exchange between the entity and its customer. Although the entity might consider those goods or services to be marketing incentives or incidental goods or services, they are goods or services for which the customer pays and to which the entity should allocate consideration for purposes of revenue recognition. However, the boards observed that in some cases, an entity might provide incentives to a customer that would not represent a performance obligation if those incentives are provided independently of the contract that they are designed to secure. (See paragraphs BC386–BC395 for additional discussion on marketing incentives and the accounting for customer options to acquire additional goods or services.)
- BC90 For similar reasons, the boards decided not to exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential.² Instead, an entity should assess whether those performance obligations are immaterial to its financial statements as described in IAS 8 and FASB Concepts Statement No. 8 *Conceptual Framework for Financial Reporting*.
- BC91 To help an entity identify the promised goods or services, IFRS 15 provides examples of the types of promises that can represent goods or services to the customer. In response to feedback received, the boards clarified that the following can also represent promised goods or services:
- (a) providing a service of standing ready or making goods or services available (see paragraph BC160); and
 - (b) granting rights to goods or services to be provided in the future (see paragraph BC92).
- BC92 The boards observed that it was important to clarify that granting a right to goods or services to be provided in the future, such as when an entity makes a promise to provide goods or services to its customer's customer, would give rise to performance obligations for the entity. Those types of promises exist in distribution networks in various industries but are particularly common in the automotive industry. For example, when a manufacturer sells a motor vehicle to its customer (a dealer), the manufacturer may also promise to provide additional goods or services (such as maintenance) to the dealer's customer. IFRS 15 requires an entity to identify all of the promises—both explicit and implicit—that are made to the customer as part of the contract with that customer. Consequently, a promise of a good or service (such as maintenance) that the customer can pass on to its customer would be a performance obligation if the promise could be identified (explicitly or implicitly) in the contract with the customer. However, the boards noted that some promised goods or services might not represent performance obligations if those promises did not exist (explicitly or implicitly) at the time that the parties agreed to the contract.
- BC93 The boards also clarified that an entity should not account for activities it may perform that do not transfer goods or services to the customer. This may occur in many contracts in which an entity undertakes separate activities that do not directly transfer goods or services to the customer (for example, service contracts that require significant setup costs), even though those activities are required to successfully transfer the goods or services for which the customer has contracted. The boards decided that including those activities as performance obligations would have been inconsistent with the core revenue recognition principle because those activities do not result in a transfer of goods or services to the customer.

² The FASB subsequently decided to amend Topic 606 to state that an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial within the context of the contract with the customer. The IASB's considerations for deciding not to make similar amendments to IFRS 15 are explained in paragraphs BC116A–BC116E.

Identifying when promises represent performance obligations (paragraphs 22–30)

- BC94 Contracts with customers can include many promises to transfer goods or services. In the Discussion Paper, the boards proposed that an entity should review the timing of the transfer of the promised goods or services to identify the performance obligations that it should account for separately. Respondents to the Discussion Paper were concerned that this proposal would have required an entity to account separately for every promised good or service in a contract that is transferred at a different time, which would not be practical for many contracts, especially for long-term service and construction contracts. Consequently, the boards decided to provide clearer requirements that result in an entity identifying performance obligations in a way that is practical and results in a pattern of revenue recognition that faithfully depicts the transfer of goods or services to the customer.
- BC95 In developing those requirements, the boards observed that in many contracts, identifying the promised goods or services that an entity should account for separately is straightforward. Consequently, the boards developed a principle for identifying performance obligations that separates promised goods or services in a relevant way when applied across the various industries and transactions within the scope of IFRS 15. That principle is the notion of a distinct good or service. The term ‘distinct’, in an ordinary sense, suggests something that is different, separate or dissimilar. A majority of respondents agreed with using the principle of distinct goods or services to identify the performance obligations in a contract. However, many asked the boards to refine and further clarify the requirements for determining when a good or service is distinct.
- BC96 Consequently, the boards decided that for a good or service to be distinct, the criteria in paragraph 27 of IFRS 15 must be met. The boards’ deliberations of those criteria are discussed in the following sections.

Capable of being distinct

- BC97 The boards decided that a good or service must possess some specified minimum characteristics to be accounted for separately. Specifically, the good or service must be capable of being distinct—that is, the good or service is capable of providing a benefit to the customer either on its own or together with other resources that are readily available to the customer. The boards were concerned that requiring an entity to account separately (and estimate a stand-alone selling price) for a good or service that is not capable of providing a benefit to the customer might result in information that would not be relevant to users of financial statements. For example, if an entity transferred a machine to the customer, but the machine is only capable of providing a benefit to the customer after an installation process that only the entity can provide, the machine would not be distinct.
- BC98 The 2010 Exposure Draft addressed this notion of a minimum characteristic by proposing that a good or service should have a distinct function—that is, the good or service should have utility either on its own or together with other goods or services that the customer has acquired from the entity or that are sold separately by the entity or another entity. Respondents requested additional guidance on the meaning of ‘distinct function’ because they considered that almost any element of a contract could have utility in combination with other goods or services.
- BC99 Consequently, the boards refined the notion of distinct function and developed the criterion in paragraph 27(a) of IFRS 15. In addition, the boards included the requirements in paragraph 28 of IFRS 15 (which were derived from the Basis for Conclusions on the 2011 Exposure Draft) to help an entity apply that criterion and assess whether a customer can benefit from the good or service on its own or together with other resources. Those requirements focus on the notion of economic benefits, which many respondents explained was helpful in assessing whether the customer can benefit from the good or service on its own or together with other resources. The boards noted that, conceptually, any good or service that is regularly sold separately should be able to be used on its own or with other resources. Otherwise, there would be no market for an entity to provide that good or service on a stand-alone basis.
- BC100 The boards observed that the assessment of whether the ‘customer can benefit from the goods or services on its own’ should be based on the characteristics of the goods or services themselves instead of the way in which the customer may use the goods or services. Consequently, an entity

would disregard any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity.

- BC101 The attributes of a distinct good or service are comparable to previous revenue recognition requirements for identifying separate deliverables in a multiple-element arrangement, which specified that a delivered item must have 'value to the customer on a stand-alone basis' for an entity to account for that item separately. However, the boards decided against using that terminology to avoid the implication that an entity must assess the customer's intended use for the promised goods or services in identifying the performance obligations in a contract. The boards observed that it would be difficult, if not impossible, for an entity to know the customer's intentions in a given contract.

Distinct within the context of the contract³

- BC102 In some cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, those goods or services should not be accounted for separately because it would not result in a faithful depiction of the entity's performance in that contract. As an example, many construction-type and production-type contracts involve transferring to the customer many goods and services that are capable of being distinct (such as various building materials, labour and project management services). However, identifying all of those individual goods and services as separate performance obligations would be impractical and, more importantly, it would neither faithfully represent the nature of the entity's promise to the customer nor result in a useful depiction of the entity's performance. This is because it would result in an entity recognising and measuring revenue when the materials and other inputs to the construction or production process are provided, instead of recognising and measuring revenue when the entity performs (and uses those inputs) in the construction or production of the item (or items) for which the customer has contracted. Consequently, the boards decided that, when identifying whether goods or services are distinct, an entity should not only consider the characteristics of an individual good or service (see paragraph 27(a) of IFRS 15) but should also consider whether the promise to transfer the good or service is separately identifiable (ie distinct within the context of the contract, see paragraph 27(b) of IFRS 15).
- BC103 During the development of IFRS 15, the existence of 'separable risks' was identified as a basis for assessing whether a good or service is distinct within the context of the contract. In that assessment, the individual goods or services in a bundle would not be distinct if the risk that an entity assumes to fulfil its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services in that bundle. The boards considered whether to specify 'separable risks' as a necessary attribute of a distinct good or service. However, the boards decided that the concept of 'separable risks' may not be a practical criterion for determining whether a good or service is distinct.
- BC104 To make the notion of separable risks more operable, the boards considered other approaches for articulating the notion. However, the boards rejected those approaches for the following reasons:
- (a) distinct profit margin—in some cases, entities may decide to assign the same margin to various goods or services, even though those goods or services use different resources and are subject to different risks. In addition, for some goods or services, especially software and other types of intellectual property, cost is not a significant factor in determining price and, therefore, margins could be highly variable because they may be determined by the customer's ability to pay or to obtain substitute goods or services from another entity.
 - (b) criteria based on the notions of goods or services that are significantly modified or customised, and highly interrelated goods or services that require an entity to provide a significant service of integrating those goods or services—respondents explained that

³ *Clarifications to IFRS 15* issued in April 2016 amended paragraphs 27 and 29 of IFRS 15 to clarify that the objective of assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable is to determine whether the entity's promise is to transfer (a) each of those goods or services; or (b) a combined item or items to which the promised goods or services are inputs. Amendments were also made to the factors in paragraph 29 to more clearly align them with the revised 'separately identifiable' principle. Paragraphs BC102–BC112 should therefore be read together with paragraphs BC116F–BC116Q, which explain the boards' considerations in making these amendments.

while these are relevant factors to consider to determine whether a good or service is distinct, expressing those factors as criteria could be too restrictive because they could force bundling or unbundling that did not reflect the economics of the arrangement.

- BC105 Consequently, the boards decided to specify in paragraph 27(b) of IFRS 15 that the objective in identifying whether a promised good or service is distinct within the context of the contract is to determine whether an entity's promise to transfer that good or service is separately identifiable from other promises in the contract. The notion of 'separately identifiable' is based on the notion of separable risks in paragraph BC103 (ie whether the risk that an entity assumes to fulfil its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services). The boards observed that determining whether the entity's promise to transfer a good or service is separately identifiable requires judgement, taking into account all of the facts and circumstances. The boards decided to assist entities in making that judgement by including the factors in paragraph 29 of IFRS 15.
- BC106 The boards observed that the factors in paragraph 29 of IFRS 15 are not mutually exclusive. On the contrary, because the factors are based on the same underlying principle of inseparable risks, the boards noted that in many cases more than one of the factors might apply to a contract with a customer. However, each factor was developed because it may be more applicable for particular contracts or industries. The rationale for each factor is discussed in paragraphs BC107–BC112.

Significant integration service (paragraph 29(a))

- BC107 In circumstances in which an entity provides an integration service, the risk of transferring individual goods or services is inseparable, because a substantial part of the entity's promise to a customer is to ensure the individual goods or services are incorporated into the combined output. Thus, the individual goods or services are inputs to produce a single output. The boards observed that this factor may be relevant in many construction contracts in which the contractor provides an integration (or contract management) service to manage and co-ordinate the various construction tasks and to assume the risks associated with the integration of those tasks. Moreover, the integration service will require a contractor to co-ordinate the tasks performed by any subcontractors and ensure that those tasks are performed in accordance with the contract specifications, thus ensuring the individual goods or services are appropriately incorporated into the combined item for which the customer has contracted.
- BC108 The boards observed that this factor could apply to industries other than the construction industry. For example, some software development contracts with significant integration services will similarly have promised goods and services that meet the criterion in paragraph 27(b) of IFRS 15. However, the boards did not intend for this factor to be applied too broadly to software integration services for which the risk that the entity assumes in integrating the promised goods or services is negligible (for example, a simple installation of software that does not require significant modification). Therefore, to provide some additional clarification for many software-type contracts, the boards included the factor in paragraph 29(b) of IFRS 15.

Significant modification or customisation (paragraph 29(b))

- BC109 In some industries, such as the software industry, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customises another good or service. This is because if a good or service modifies or customises another good or service in the contract, each good or service is being assembled together (ie as inputs) to produce a combined output for which the customer has contracted.
- BC110 For example, an entity may promise to provide a customer with existing software and also promise to customise that software so that it will function with the customer's existing infrastructure such that the entity is providing the customer with a fully integrated system. In this case, if the customisation service requires the entity to significantly modify the existing software in such a way that the risks of providing the software and the customisation service are inseparable, the entity may conclude that the promises to transfer the software and the customisation service would not be separately identifiable and, therefore, those goods or services would not be distinct within the context of the contract.

Highly dependent or highly interrelated (paragraph 29(c))

- BC111 The boards decided to include the factor in paragraph 29(c) of IFRS 15 because, in some cases, it might be unclear whether the entity is providing an integration service (see paragraph 29(a)) or whether the goods or services are significantly modified or customised (see paragraph 29(b)). However, the individual goods and services in the contract may still not be separately identifiable from the other goods or services promised in the contract. This may be because the goods or services are highly dependent on, or highly interrelated with, other promised goods or services in the contract in such a way that the customer could not choose to purchase one good or service without significantly affecting the other promised goods or services in the contract.
- BC112 Consider the following example—an entity agrees to design an experimental new product for a customer and to manufacture 10 prototype units of that product. The specifications for the product include functionality that has yet to be proved. Consequently, the entity will be required to continue to revise the design of the product during the construction and testing of the prototypes and make any necessary modifications to in-progress or completed prototypes. The entity expects that most or all of the units to be produced may require some rework because of design changes made during the production process. In that case, the customer may not be able to choose whether to purchase only the design service or the manufacturing service without significantly affecting one or the other. This is because the risk of providing the design service is inseparable from the manufacturing service. Thus, although each promise may have benefit on its own, within the context of the contract, they are not separately identifiable. This is because the entity determines that each promise is highly dependent on, and highly interrelated with, the other promises in the contract.

A series of distinct goods or services that are substantially the same and have the same pattern of transfer (paragraph 22(b))

- BC113 The boards decided to specify that a promise to transfer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer would be a single performance obligation if two criteria are met. The boards decided to include this notion as part of the definition of a performance obligation to simplify the application of the model and to promote consistency in the identification of performance obligations in circumstances in which the entity provides the same good or service consecutively over a period of time (for example, a repetitive service arrangement). To be accounted for as a single performance obligation, each of those promised goods or services must be performance obligations satisfied over time in accordance with paragraph 35 of IFRS 15.
- BC114 The boards observed that without this part of the definition, applying the model might present some operational challenges when an entity provides a series of distinct goods or services that are substantially the same. Otherwise, the entity would be required to identify multiple distinct goods or services, allocate the transaction price to each of the resulting performance obligations on a stand-alone selling price basis and then recognise revenue when those performance obligations are satisfied. For example, in a repetitive service contract such as a cleaning contract, transaction processing or a contract to deliver electricity, an entity would be required to allocate the overall consideration to each increment of service (for example, each hour of cleaning) to be provided in the contract. The boards decided that it would not be cost-effective to apply the model in this manner and determined that including paragraph 22(b) of IFRS 15 as part of the definition of a performance obligation would alleviate costs. This is because when paragraph 22(b) of IFRS 15 applies (ie the contract includes a promise to transfer a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer), an entity will identify a single performance obligation and allocate the transaction price to the performance obligation. The entity will then recognise revenue by applying a single measure of progress to that performance obligation.
- BC115 The boards noted that if an entity determines it has a performance obligation that meets the criterion in paragraph 22(b) of IFRS 15, an entity should consider the distinct goods or services in the contract, rather than the performance obligation, for the purposes of contract modifications and the allocation of variable consideration.

- BC116 In their redeliberations, the boards observed that paragraph 22(b) of IFRS 15 applies to goods or services that are delivered consecutively, rather than concurrently. The boards noted that IFRS 15 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations.

Clarifications to IFRS 15 (amendments issued in April 2016)

Promised goods or services that are immaterial within the context of the contract

- BC116A The TRG discussed an implementation question about whether an entity should identify items or activities as promised goods or services that were not identified as deliverables or components under previous revenue Standards. A specific concern was raised about the boards' decision (see paragraph BC90) not to exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential. Some stakeholders held the view that IFRS 15 might require an entity to identify significantly more performance obligations than would have been the case under previous revenue Standards.
- BC116B In response to stakeholders' concerns, the FASB decided to amend Topic 606 to state that an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial within the context of the contract with the customer. The FASB decided to specify that an entity is required to consider whether a promised good or service is material only at the contract level because it would be unduly burdensome to require an entity to aggregate and determine the effect on its financial statements of those items or activities determined to be immaterial at the contract level. In addition, the FASB decided to specify that an entity is required to accrue the costs, if any, to transfer immaterial goods or services to the customer in instances in which the costs will be incurred after the satisfaction of the performance obligation (and recognition of revenue) to which those immaterial goods or services relate.
- BC116C Having considered the wider implications of amending IFRS 15, the IASB decided that it was not necessary to incorporate similar wording into IFRS 15. The TRG's discussion highlighted that the concerns raised primarily related to potential changes to practice under US GAAP. Previous revenue Standards under IFRS did not contain similar language to the guidance issued by the staff of the US Securities and Exchange Commission on inconsequential or perfunctory performance obligations. The TRG's discussion also indicated that IFRS stakeholders can understand and apply the requirements of IFRS 15 in this area.
- BC116D In its deliberations, the IASB expressed the view that the concerns raised relate to the application of materiality concepts rather than the application of the requirements in IFRS 15. As described in paragraph BC84, the boards intended the notion of a performance obligation to be similar to the notions of deliverables, components or elements of a contract in previous revenue Standards. The IASB noted that IFRS 15 requires an entity to identify performance obligations rather than promised goods or services. Accordingly, although an entity makes an assessment of the goods or services promised in a contract in order to identify material performance obligations, the boards did not intend to require an entity to individually identify every possible promised good or service.
- BC116E In reaching its decision, the IASB also observed that the explanation in paragraph BC90 should be read within the context of the boards' explanation of the development of IFRS 15 rather than as implying that an entity is required to identify perfunctory or inconsequential goods or services promised in a contract. One of the reasons that the IASB decided not to introduce an exemption for perfunctory or inconsequential performance obligations is that it was not considered necessary, both because of how the concept of 'distinct' is applied and also because of the application of materiality. In assessing promised goods or services and identifying performance obligations, entities should consider not only materiality considerations but also the overall objective of IFRS 15. The IASB further noted that materiality is an overarching concept that applies throughout IFRS and not just when it is mentioned explicitly.

Identifying performance obligations (paragraphs 27–30)

- BC116F The TRG discussed issues relating to the principle in paragraph 27(b) regarding when a promised good or service is separately identifiable (ie distinct within the context of a contract) and the supporting factors in paragraph 29. The discussion informed the boards about potential diversity in stakeholders' understanding and indicated that there was a risk of paragraph 29(c) being applied more broadly than intended, resulting in promised goods or services being inappropriately combined and accounted for as a single performance obligation. Stakeholders asked about the application of this factor to scenarios in which one of the promised goods or services is dependent on the transfer of the other, such as a contract for equipment and related consumables that are required for the equipment to function. Some stakeholders suggested that, although the promised goods or services may be capable of being distinct, if one of the goods or services was dependent on the other, the promised goods or services would not be distinct within the context of the contract.
- BC116G In the light of the TRG discussions, the IASB was initially of the view that the discussions highlighted educational needs and that, given the nature of the issues raised, amendments to IFRS 15 were not required and that the examples accompanying IFRS 15 could be clarified to illustrate the application of the requirements. Consequently, in its Exposure Draft *Clarifications to IFRS 15*, the IASB proposed to add some new examples, and to amend some of the existing examples that accompany IFRS 15. The FASB decided to propose amendments to Topic 606 to clarify the guidance relating to the identification of performance obligations. In particular, their proposed amendments included expanding the articulation of the 'separately identifiable' principle and reframing the existing factors in paragraph 606-10-25-21 (paragraph 29 of IFRS 15) to align them with the amended principle.
- BC116H Some respondents to the IASB's Exposure Draft asked for the amendments proposed by the FASB to be incorporated into paragraph 29 of IFRS 15. They expressed concerns about differences in wording between IFRS and US GAAP and also indicated that the FASB's proposed amendments would improve the understanding of the separately identifiable principle and the operability of the requirements. Step 2 is a fundamental part of IFRS 15 that affects accounting in subsequent steps of the revenue recognition model. Consequently, in its redeliberations of the amendments the IASB concluded that the benefits of retaining converged requirements on this topic outweigh the potential costs of amending the requirements. Accordingly, the IASB decided to amend IFRS 15 to clarify the principle and the factors that indicate when two or more promises to transfer goods or services are not separately identifiable. Those amendments are the same as the FASB's related amendments to Topic 606.
- BC116I Although the wording describing the separately identifiable principle in paragraph 29 has been amended, the amendments clarify the boards' intentions and are not a change to the underlying principle. The boards observed that applying the principle in paragraph 27(b) requires judgement, taking into account facts and circumstances (see paragraph BC105). Even after amending the factors in paragraph 29 of IFRS 15, the boards recognise that judgement will be needed to determine whether promised goods or services are distinct within the context of the contract.
- BC116J The amendments are intended to convey that an entity should evaluate whether its promise, within the context of the contract, is to transfer each good or service individually or a combined item (or items) that comprises the individual goods or services promised in the contract. Therefore, entities should evaluate whether the promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items). In many cases, the inputs to a combined item concept might be further explained as a situation in which an entity's promise to transfer goods or services results in a combined item that is more than (or substantively different from) the sum of those individual promised goods and services. For example, in a contract to build a wall, the promise to provide bricks and the promise to provide labour are not separately identifiable from each other within the context of the contract because those promises together comprise the promise to the customer to build the wall.
- BC116K The boards previously considered the concept of 'separable risks' (see paragraph BC103) as an alternative basis for assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract. Although the boards decided not to use this terminology in IFRS 15, the notion of separable risks continues to influence the separately identifiable principle. The evaluation of whether an entity's promise is separately identifiable considers the relationship between the various goods or services within the contract in the context

of the process of fulfilling the contract. Therefore, an entity should consider the level of integration, interrelation or interdependence among the promises to transfer goods or services. The boards observed that rather than considering whether one item, by its nature, depends on the other (ie whether two items have a functional relationship), an entity evaluates whether there is a transformative relationship between the two items in the process of fulfilling the contract.

BC116L The boards decided to reframe the factors in paragraph 29 of IFRS 15 to more clearly align them with the revised wording of the separately identifiable principle. This clarification emphasises that the separately identifiable principle is applied within the context of the bundle of promised goods or services in the contract rather than within the context of each individual promised good or service. The separately identifiable principle is intended to identify when an entity's performance in transferring a bundle of goods or services in a contract is fulfilling a single promise to a customer. Accordingly, the boards revised the wording to emphasise that an entity should evaluate whether two or more promised goods or services each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. Furthermore, the boards concluded that it may be clearer to structure those factors to identify when the promises in a bundle of promised goods or services are *not* separately identifiable and, therefore, constitute a single performance obligation.

BC116M In addition to reframing the factors in the context of a bundle of goods or services, the boards amended the factor relating to a significant integration service in paragraph 29(a) of IFRS 15 to clarify two related issues—that application of this factor is not limited to circumstances that result in a single output, and that a combined output may include more than one phase, element or unit. This concept is illustrated by the example in paragraph BC112, in which an entity agrees to design an experimental product for a customer and to manufacture 10 prototype units of that product. In the example, the design and production of the units is an iterative process and the significant integration service provided by the entity relates to all 10 prototype units.

BC116N The TRG's discussions also highlighted that some stakeholders may have been interpreting the factors supporting paragraph 27(b) as a series of criteria. Paragraph 29, where the factors are set out, provides a non-exhaustive list of factors to consider; not all of those factors need to exist (or not exist) to conclude that the entity's promises to transfer goods or services are not (are) separately identifiable. Similarly, the boards also noted that the factors are not intended to be criteria that are evaluated independently of the separately identifiable principle. Given the wide variety of revenue arrangements that are within the scope of IFRS 15, the boards expect that there will be some instances for which the factors will be less relevant to the evaluation of the separately identifiable principle. Consequently, entities should consider the objective of the principle, not just the factors provided in paragraph 29 of IFRS 15.

BC116O Stakeholders also asked about the effect of contractual restrictions on the identification of performance obligations. Accordingly, one of the examples added (Case D of Example 11) illustrates the boards' observation in paragraph BC100 of IFRS 15 that an entity should focus on the characteristics of the promised goods or services themselves instead of on the way in which the customer might be required to use the goods or services.

BC116P The IASB decided that it was not necessary to add some of the examples that the FASB included in its amendments to Topic 606. In particular, the IASB concluded that an example relating to whether an anti-virus software licence is distinct from when-and-if-available updates to the software during the licence period (Example 10, Case C in Topic 606) was unnecessary. The IASB thought that this additional example was not required because Example 55 that accompanies IFRS 15 illustrates the application of the requirements on identifying performance obligations to a similar fact pattern.

BC116Q Respondents to the Exposure Draft expressed concern that the proposed Example 10, Case B may imply that any contract manufacturing or similar arrangement would be a single performance obligation comprising goods that are not distinct. There are some similarities between the fact pattern in the example and other contracts with customers that involve project management, the production of customised goods or the manufacture of a series of identical goods. However, an entity should evaluate the nature of its promise(s) to a customer within the context of the contract. Example 10, Case B illustrates a scenario in which the entity is contractually required to undertake a significant effort to establish a customised production process specifically in order to produce the highly complex, specialised devices for which the customer has contracted. As a result, the entity's promise is to establish and provide a service of producing the contracted devices based on the

customer's specifications. In contrast, other manufacturing scenarios may involve the development of a production process that can be used to produce goods for multiple contracts with the same or additional customers. In that case, the contract may not include a promise to establish a customised production process.

Shipping and handling activities

BC116R Some stakeholders in the United States expressed differing views about when shipping and handling activities that occur after the transfer of control to the customer should be accounted for as a promised service or as a fulfilment activity. Under previous revenue Standards, entities often did not account for shipping provided in conjunction with the sale of their goods as an additional service. As a result, some stakeholders raised cost-benefit concerns and asked whether relief should be provided in respect of shipping and handling activities from the general requirement to assess the goods or services promised in a contract with a customer in order to identify performance obligations.

BC116S When the boards discussed these concerns, board members noted that shipping and handling activities that occur before the customer obtains control of the related good are fulfilment activities. However, if control of a good has been transferred to a customer, shipping and handling services are provided in relation to the customer's good, which may indicate that the entity is providing a service to the customer.

BC116T In response to the cost-benefit concerns raised by stakeholders, the FASB decided to amend Topic 606 to:

- (a) permit an entity, as an accounting policy election, to account for shipping and handling activities that occur after the customer has obtained control of a good as fulfilment activities; and
- (b) explicitly state that shipping and handling activities that occur before the customer obtains control of the related good are fulfilment activities.

BC116U Having considered the wider implications of amending IFRS 15, the IASB decided not to make a similar amendment, for the following reasons:

- (a) An accounting policy choice for shipping and handling activities after control of goods has been transferred to the customer would create an exception to the revenue recognition model and potentially reduce comparability between entities. Paragraph 22 of IFRS 15 requires an entity to assess the goods or services promised in a contract with a customer in order to identify performance obligations. The introduction of a policy choice would override this requirement.
- (b) In addition, a policy choice is applicable to all entities. Consequently, it is possible that entities with significant shipping operations would make different policy elections. This would make it more difficult for users of financial statements to understand and compare the revenue reported by different entities, including those within the same industry.

The IASB acknowledged that, because the policy choice is not available in IFRS 15, this gives rise to a difference between IFRS 15 and Topic 606.

Satisfaction of performance obligations (paragraphs 31–45)

BC117 Revenue is recognised when (or as) goods or services are transferred to a customer. This is because an entity satisfies its performance obligation by transferring control of the promised good or service underlying that performance obligation to the customer. Consequently, assessing when control of a good or service is transferred is a critical step in applying IFRS 15.

Control

BC118 Most previous revenue Standards required an entity to assess the transfer of a good or service by considering the transfer of risks and rewards of ownership. However, the boards decided that an entity should assess the transfer of a good or service by considering when the customer obtains control of that good or service, for the following reasons:

- (a) Both goods and services are assets that a customer acquires (even if many services are not recognised as an asset because those services are simultaneously received and consumed by the customer), and the boards' existing definitions of an asset use control to determine when an asset is recognised or derecognised.
- (b) Assessing the transfer of goods or services using control should result in more consistent decisions about when goods or services are transferred, because it can be difficult for an entity to judge whether an appropriate level of the risks and rewards of ownership of a good or service has been transferred to the customer if the entity retains some risks and rewards.
- (c) A risks-and-rewards approach could conflict with identifying performance obligations. For example, if an entity transfers a product to a customer but retains some risks associated with that product, an assessment based on risks and rewards might result in the entity identifying a single performance obligation that could be satisfied (and therefore revenue would be recognised) only after all the risks are eliminated. However, an assessment based on control might appropriately identify two performance obligations—one for the product and another for a remaining service, such as a fixed price maintenance agreement. Those performance obligations would be satisfied at different times.

BC119 Many respondents to both the 2010 and the 2011 Exposure Drafts agreed with using control to determine when a good or service is transferred to a customer. However, some respondents indicated that the transfer of the risks and rewards of ownership is sometimes a helpful indicator that control has transferred (see paragraph BC154).

Developing the notion of control

BC120 The boards' description of control is based on the meaning of control in the definitions of an asset in the boards' respective conceptual frameworks. Thus, the boards determined that control of a promised good or service (ie an asset) is the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The components that make up the description of control are explained as follows:

- (a) ability—a customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognise revenue. For example, in a contract that requires a manufacturer to produce an asset for a particular customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the entity should not recognise revenue until the customer has actually obtained that right (which, depending on the contract, might occur during production or afterwards).
- (b) direct the use of—a customer's ability to direct the use of an asset refers to the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset.
- (c) obtain the benefits from—the customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). A customer can obtain the benefits directly or indirectly in many ways, such as by using, consuming, disposing of, selling, exchanging, pledging or holding an asset.

BC121 The boards observed that the assessment of when control has transferred could be applied from the perspective of either the entity selling the good or service or the customer purchasing the good

or service. Consequently, revenue could be recognised when the seller surrenders control of a good or service or when the customer obtains control of that good or service. Although in many cases both perspectives lead to the same result, the boards decided that control should be assessed primarily from the perspective of the customer. That perspective minimises the risk of an entity recognising revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer.

Applying the notion of control

BC122 As described in paragraph BC119, many respondents agreed with using control as the basis for assessing when the transfer of a promised good or service (ie an asset) occurs. However, most respondents to the 2010 Exposure Draft explained that the definition was most helpful when applied to performance obligations for the transfer of goods. They commented that applying the concept of control is straightforward in those cases because, typically, it is clear that an asset has transferred from the entity to its customer. They noted, however, that the requirements were more difficult to apply to performance obligations for services and construction-type contracts, because it could be difficult to determine when a customer obtains control of a service. This is because in many service contracts the service asset is simultaneously created and consumed and, therefore, is never recognised as an asset by the customer. Even in the case of a construction contract in which there is a recognisable asset, it can be difficult to assess whether a customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, a partially completed asset that the seller is creating. Consequently, many respondents in the construction industry were concerned that they would be required to change their revenue recognition policy from using a percentage-of-completion method to a completed contract method (ie on the basis that the transfer of assets occurs only upon transfer of legal title or physical possession of the finished asset, which typically occurs upon contract completion). Those respondents explained that the outcome of applying the completed contract method to their contracts with customers would not be a faithful depiction of the economics of those contracts.

BC123 As a result, some respondents suggested that the boards provide guidance for the transfer of control of services separately from the guidance for goods. However, the boards observed that it would be difficult to clearly define a service and not all contracts that are commonly regarded as services result in a transfer of resources to customers over time. Furthermore, the boards decided that the notion of control should apply equally to both goods and services. Consequently, to address respondents' concerns, the boards decided to specify requirements that focus on the attribute of the timing of when a performance obligation is satisfied (ie when a good or service is transferred to a customer). Accordingly, IFRS 15 includes criteria for determining whether a performance obligation is satisfied over time. Those criteria are explained in the following paragraphs.

Performance obligations satisfied over time (paragraphs 35–37)

BC124 The boards developed the criteria in paragraph 35 of IFRS 15 to provide an objective basis for assessing when control transfers over time and, thus, when a performance obligation is satisfied over time.

Customer simultaneously receives and consumes benefits as entity performs (paragraph 35(a))

BC125 In many typical service contracts, the entity's performance creates an asset only momentarily, because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs and, thus, the entity's performance obligation is satisfied over time. For example, consider an entity that promises to process transactions on behalf of a customer. The customer simultaneously receives and consumes a benefit as each transaction is processed.

BC126 The boards observed that there may be service-type contracts in which it is unclear whether the customer receives and consumes the benefit of the entity's performance over time. This is because the notion of 'benefit' can be subjective. Consider, for example, a freight logistics contract in which the entity has agreed to transport goods from Vancouver to New York City. Many respondents suggested that the customer receives no benefit from the entity's performance until

the goods are delivered to New York City. However, the boards observed that the customer does benefit from the entity's performance as it occurs because if the goods were delivered only part way (for example, to Chicago), another entity would not need to substantially re-perform the entity's performance to date—that is, another entity would not need to take the goods back to Vancouver to deliver them to New York City. The boards observed that, in those cases, the assessment of whether another entity would need to substantially re-perform the performance completed to date can be used as an objective basis for determining whether the customer receives benefit from the entity's performance as it is provided.

- BC127 The boards decided that an entity should disregard any contractual or practical limitations when it assesses the 'simultaneously receives and consumes' criterion and whether another entity would need to substantially re-perform the performance completed to date. This is because the objective of this criterion is to determine whether control of the goods or services has already been transferred to the customer. This is done by using a hypothetical assessment of what another entity would need to do if it were to take over the remaining performance. Thus, actual practical or contractual limitations on the remaining performance would have no bearing on the assessment of whether the entity has transferred control of the goods or services provided to date.
- BC128 The boards also observed that this criterion is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical in cases in which the entity's performance results in an asset (such as work-in-progress). Consequently, an entity that applies IFRS 15 to contracts in which the entity's performance results in an asset (which could be intangible) being created or enhanced should consider the criteria in paragraph 35(b) and (c) of IFRS 15.

Performance creates or enhances an asset that the customer controls as it is created (paragraph 35(b))

- BC129 The boards included this criterion to address situations in which an entity's performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced. In those cases, because the customer controls any work in progress, the customer is obtaining the benefits of the goods or services that the entity is providing and, thus, the performance obligation is satisfied over time. For example, in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in progress arising from the entity's performance.
- BC130 The boards observed that the basis for this criterion is consistent with the rationale for using the 'percentage-of-completion' revenue recognition approach in previous revenue guidance in US GAAP. That guidance acknowledged that in many construction contracts the entity has, in effect, agreed to sell its rights to the asset (ie work-in-progress) as the entity performs. Accordingly, the parties have agreed, in effect, to a continuous sale (ie the customer controls the work-in-progress) that occurs as the work progresses.
- BC131 Many respondents explained that this criterion would be straightforward and helpful in cases in which the customer clearly controls the asset that is being constructed or enhanced. However, the boards observed that for some performance obligations, it may be unclear whether the asset that is created or enhanced is controlled by the customer. Consequently, it may be more challenging to determine when control transfers in those cases and, therefore, the boards developed a third criterion in paragraph 35(c) of IFRS 15.

Performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (paragraph 35(c))

- BC132 The boards observed that, in some cases, applying the criteria in paragraph 35(a) and (b) of IFRS 15 could be challenging. Consequently, the boards developed a third criterion to help with the assessment of control. The boards observed that this criterion may be necessary for services that may be specific to a customer (for example, consulting services that ultimately result in a professional opinion for the customer) but also for the creation of tangible (or intangible) goods.
- BC133 The notions of 'alternative use' and 'right to payment' are described in the following paragraphs.

Performance does not create an asset with an alternative use

- BC134 The boards developed the notion of alternative use to exclude the circumstances in which the entity's performance would not result in the transfer of control of goods or services to the customer over time. This is because when the entity's performance creates an asset with an alternative use to the entity, the entity could readily direct the asset to another customer and, therefore, the customer would not control the asset as it is being created. This may occur in the creation of many standard inventory-type items for which the entity has the discretion to substitute across different contracts with customers. In those cases, the customer cannot control the asset because the customer does not have the ability to restrict the entity from directing that asset to another customer.
- BC135 Conversely, when an entity creates an asset that is highly customised for a particular customer, the asset would be less likely to have an alternative use. This is because the entity would incur significant costs to reconfigure the asset for sale to another customer (or would need to sell the asset for a significantly reduced price). In that case, the customer could be regarded as receiving the benefit of that performance and, consequently, as having control of the goods or services (ie the asset being created) as the performance occurs. (However, an entity would also need to consider whether a right to payment exists to conclude that control transfers over time, see paragraphs BC142–BC148.)
- BC136 In assessing whether the asset has an alternative use, the entity would need to consider practical limitations and contractual restrictions on directing the asset for another use. In determining whether the entity is limited practically from directing the asset for another use, the boards decided that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer. This is because, for some assets, it is not the period of time for which the asset has no alternative use that is the critical factor in making the assessment but, instead, whether the asset that is ultimately transferred could be redirected without a significant cost of rework. This may occur in some manufacturing contracts in which the basic design of the asset is the same across all contracts, but the customisation is substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.
- BC137 Although the level of customisation might be a helpful factor to consider when assessing whether an asset has an alternative use, the boards decided that it should not be a determinative factor. This is because in some cases (for example, some real estate contracts), an asset may be standardised but may still not have an alternative use to an entity, as a result of substantive contractual restrictions that preclude the entity from readily directing the asset to another customer. If a contract precludes an entity from transferring an asset to another customer and that restriction is substantive, the entity does not have an alternative use for that asset because it is legally obliged to direct the asset to the customer. Consequently, this indicates that the customer controls the asset as it is created, because the customer has the present ability to restrict the entity from directing that asset to another customer (an entity would also need to consider whether a right to payment exists to conclude that control of the asset transfers over time as it is created, see paragraphs BC142–BC148). The boards observed that contractual restrictions are often relevant in real estate contracts, but might also be relevant in other types of contracts.
- BC138 The boards also noted that contractual restrictions that provide a protective right to the customer would not be sufficient to establish that an asset has no alternative use to the entity. The boards observed that a protective right typically results in the entity having the practical ability to physically substitute or redirect the asset without the customer being aware of or objecting to the change. For example, a contract might state that an entity cannot transfer a good because a customer has legal title to the goods in the contract. However, the customer's legal title to the goods is intended to protect the customer in the event of the entity's liquidation and the entity can physically substitute and redirect the goods to another customer for little cost. In this example, the contractual restriction is merely a protective right and does not indicate that control of the goods have transferred to the customer.
- BC139 Some respondents observed that requiring an entity to consider contractual and practical restrictions in paragraph 35(c) of IFRS 15 seems to contradict the requirements in paragraph B4 of IFRS 15 to ignore contractual and practical limitations when applying the criterion in paragraph 35(a) of IFRS 15. The boards noted that this difference is appropriate. Although the objective of both criteria is to assess when control transfers over time, each criterion provides a different

method for assessing when that control transfers, because the criteria were designed to apply to different scenarios.

- BC140 The boards decided that the assessment of alternative use should be completed only at contract inception and should not be updated. Otherwise, an entity would need to continually reassess whether the asset has an alternative use, which could lead to a pattern of performance (and, therefore, revenue recognition) that is not useful.
- BC141 The boards also decided that while the notion of alternative use is a necessary part of the criterion in paragraph 35(c), it is not enough to conclude that a customer controls an asset. Consequently, the boards decided that to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity must also have an enforceable right to payment for performance completed to date.

The entity has an enforceable right to payment for performance completed to date

- BC142 The boards decided that there is a link between the assessment of control and the factors of no alternative use and a 'right to payment'. This is because if an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. This is consistent with other exchange contracts in which a customer would typically be obliged to pay only if it has received control of goods or services in the exchange. Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance.
- BC143 The boards intended the term 'right to payment' to refer to a payment that compensates an entity for its performance completed to date rather than, for example, a payment of a deposit or a payment to compensate the entity for inconvenience or loss of profit. This is because the underlying objective of the criterion is to determine whether the entity is transferring control of goods or services to the customer as an asset is being created for that customer. Consequently, assuming there is rational behaviour and that there are no broader perceived economic benefits that might exist outside the scope of the contract with the customer, the entity would only agree to transfer control of the goods or services to the customer if the entity is compensated for the costs associated with fulfilling the contract and it receives a profit margin that includes a return on those costs.
- BC144 The boards noted that the compensation to which the entity would be entitled upon termination by the customer might not always be the contract margin, because the value transferred to a customer in a prematurely terminated contract may not be proportional to the value if the contract was completed. However, the boards decided that to demonstrate compensation for performance completed to date, the compensation should be based on a reasonable proportion of the entity's expected profit margin or be a reasonable return on the entity's cost of capital. Furthermore, the boards noted that the focus should be on the amount to which the entity would be entitled upon termination rather than the amount to which the entity might ultimately be willing to settle for in a negotiation. Consequently, the boards clarified their intention about what a 'reasonable profit margin' is intended to represent in paragraph B9 of IFRS 15.
- BC145 In addition, the boards clarified that an entity need not have a present unconditional right to payment but, instead, it must have an enforceable right to demand and/or retain payment for performance completed to date if the customer were to terminate the contract without cause before completion. For example, consider a consulting contract in which the consulting entity agrees to provide a report at the end of the contract for a fixed amount that is conditional on providing that report. If the entity were performing under that contract, it would have a right to payment for performance completed to date if the terms of the contract (or other law) require the customer to compensate the entity for its work completed to date if the customer terminates the contract without cause before completion. The boards clarified this notion because the contractual payment terms in the contract might not always align with the entity's enforceable rights to payment for performance completed to date.

- BC146 A few respondents asked whether a 100 per cent non-refundable upfront payment would meet the 'right to payment for performance completed to date' criterion (ie because a 100 per cent payment would at least compensate the entity for work completed to date throughout the contract). The boards decided that that type of payment would meet that criterion if the entity's right to retain (and not refund) that payment would be enforceable if the customer terminated the contract. Furthermore, the boards noted that the right to payment should be enforceable; otherwise, it is questionable whether the entity actually has a right to payment. Consequently, the boards included the factors in paragraph B12 of IFRS 15 to help an entity determine whether the right to payment would be enforceable.
- BC147 The boards also decided to clarify that an entity could have an enforceable right to payment in some cases in which a customer might not have a right to terminate the contract or might have a right to terminate the contract only at specified times. This would be the case if the contract or other laws in the jurisdiction require the entity and the customer to complete their respective obligations (often referred to as specific performance).

Right to payment as a separate revenue recognition criterion

- BC148 The boards considered but rejected specifying a right to payment as a more overarching criterion in determining when revenue is recognised, for the following reasons:
- (a) an entity must have a contract to recognise revenue in accordance with IFRS 15 and a component of a contract is a right to payment.
 - (b) the core revenue recognition principle is about determining whether goods or services have been transferred to a customer, not whether the entity has a right to payment (although it is an important part of determining whether a contract exists—see paragraphs BC31–BC46). Including a right to payment as an overarching criterion for determining when a performance obligation is satisfied could have potentially overridden that revenue recognition principle.
 - (c) a right to payment does not necessarily indicate a transfer of goods or services (for example, in some contracts, customers are required to make non-refundable upfront payments and do not receive any goods or services in exchange). In cases in which the customer clearly receives benefits as the entity performs, as in many service contracts, the possibility that the entity will ultimately not retain the payment for its performance is addressed in the measurement of revenue. For example, in some service contracts in which the customer simultaneously receives and consumes benefits as the entity performs, the customer may be able to terminate the contract and receive a full refund of any consideration paid. The boards decided that in those cases, because the entity is transferring services to the customer, it should recognise revenue subject to an assessment of whether it should constrain the amount of the transaction price to which it is entitled (see paragraphs BC203–BC223).

Agreements for the construction of real estate

- BC149 In developing the requirements for assessing when goods or services transfer to the customer, the boards considered the diversity in practice from applying previous revenue recognition requirements in IFRS that were specific to the construction of real estate. That diversity in practice resulted from the difficulty in determining when control of real estate transferred to the customer over time by applying the previous IFRS revenue recognition criteria to complex contracts with different facts and circumstances.
- BC150 The boards envisage that the diversity in practice should be reduced by the requirements in paragraphs 35–37 of IFRS 15, which provide specific requirements for determining when goods or services transfer over time. However, the boards observe that the pattern of transfer may be different for different real estate contracts because it will depend on the relevant facts and circumstances of each contract. For example, some real estate contracts may result in an asset that cannot (under the terms of the contract) be readily directed to another customer (ie the entity's performance does not create an asset with an alternative use to the entity), and the contracts require the customer to pay for performance completed to date (thus meeting the criterion in paragraph 35(c) of IFRS 15). However, other real estate contracts that create an asset with no

alternative use to the entity may not require the customer to pay for performance completed to date. Therefore, an entity would reach a different conclusion on the pattern of transfer for those contracts.

- BC151 Some respondents applying IFRS in the residential real estate industry supported the addition of the criteria for determining whether a performance obligation is satisfied over time, because they reasoned it would assist them in assessing whether revenue could be recognised over time as construction of residential units in a multi-unit real estate development occurs. Other respondents in this industry explained that although they were able to conclude that their performance does not create an asset with an alternative use, they were unable to meet the 'right to payment for performance completed to date' criterion. This would mean that they would be able to recognise revenue only at the point in time when each unit transfers to the customer (often only after construction is complete and the customer has physical possession), which they stated would be an inappropriate depiction of their performance.
- BC152 However, the boards concluded that if either of the criteria in paragraph 35(c) of IFRS 15 is not met, recognising revenue over time would not faithfully depict the entity's performance and the entity's and the customer's respective rights and obligations in the contract. Furthermore, the boards decided that clarifying the 'no alternative use and right to payment for performance completed to date' criterion would ensure greater certainty and consistency in recognising revenue for multi-unit residential real estate developments.

Performance obligations satisfied at a point in time (paragraph 38)

- BC153 The boards decided that all performance obligations that do not meet the criteria for being satisfied over time should be accounted for as performance obligations satisfied at a point in time. For performance obligations satisfied at a point in time, the performance obligation is satisfied at the point in time when control of the goods or services transfers to the customer. The boards included indicators of the transfer of control in paragraph 38 of IFRS 15.
- BC154 Many respondents commented that the indicators were useful for contracts for the sales of goods to assist an entity in determining when it has transferred control of an asset (whether tangible or intangible). The boards included the indicator 'the customer has the significant risks and rewards of ownership of the asset' because of comments from respondents who disagreed with the boards' initial proposal to eliminate considerations of the 'risks and rewards of ownership' from the recognition of revenue. Respondents observed that risks and rewards can be a helpful factor to consider when determining the transfer of control, as highlighted by the IASB in IFRS 10 *Consolidated Financial Statements*, and can often be a consequence of controlling an asset. The boards decided that adding risks and rewards as an indicator provides additional guidance, but does not change the principle of determining the transfer of goods or services on the basis of the transfer of control.
- BC155 Some respondents questioned whether all of the indicators would need to be present for an entity to conclude that it had transferred control of a good or service. Some respondents also questioned what an entity should do if some but not all of the indicators were present. In their redeliberations, the boards emphasised that the indicators in paragraph 38 of IFRS 15 are not a list of conditions that must be met before an entity can conclude that control of a good or service has transferred to a customer. Instead, the indicators are a list of factors that are often present if a customer has control of an asset and that list is provided to assist entities in applying the principle of control in paragraph 31 of IFRS 15.
- BC156 The boards considered including an indicator that the 'design or function of the good or service is customer-specific'. However, the boards decided not to include this indicator in IFRS 15, because it would apply mainly to service contracts (for example, construction-type contracts) and it would be unnecessary in the light of the requirements for determining when performance obligations are satisfied over time. As described in paragraphs BC134–BC141, the notion of customer-specific design or function has been developed into the criterion of 'an asset with no alternative use to the entity'.
- BC157 Respondents also suggested additional indicators such as the entity's lack of continuing involvement in the good or service (for example, a call option on a delivered good). The boards

included application guidance to help an entity assess the transfer of control in circumstances in which put or call options exist in a contract with a customer (see paragraphs BC422–BC433).

Measuring progress towards complete satisfaction of a performance obligation (paragraphs 39–45 and B14–B19)

- BC158 The boards decided that when an entity determines that a performance obligation is satisfied over time, it should determine how much revenue to recognise in each reporting period by measuring its progress towards complete satisfaction of the performance obligation.
- BC159 There are various methods that an entity might use to measure its progress towards complete satisfaction of a performance obligation. Because of the breadth of the scope of IFRS 15, the boards decided that it would not be feasible to consider all possible methods and prescribe when an entity should use each method. Accordingly, an entity should use judgement when selecting an appropriate method of measuring progress towards complete satisfaction of a performance obligation. That does not mean that an entity has a ‘free choice’. The requirements state that an entity should select a method of measuring progress that is consistent with the clearly stated objective of depicting the entity’s performance—that is, the satisfaction of an entity’s performance obligation—in transferring control of goods or services to the customer.
- BC160 To meet that objective of depicting the entity’s performance, an entity would need to consider the nature of the promised goods or services and the nature of the entity’s performance. For example, in a typical health club contract, the entity’s promise is to stand ready for a period of time (ie by making the health club available), rather than providing a service only when the customer requires it. In this case, the customer benefits from the entity’s service of making the health club available. This is evidenced by the fact that the extent to which the customer uses the health club does not, in itself, affect the amount of the remaining goods or services to which the customer is entitled. In addition, the customer is obliged to pay the consideration regardless of whether it uses the health club. Consequently, in those cases, the entity would need to select a measure of progress based on its service of making goods or services available, instead of when the customer uses the goods or services made available to them.
- BC161 The boards decided that an entity should apply the selected method for measuring progress consistently for a particular performance obligation and also across contracts that have performance obligations with similar characteristics. An entity should not use different methods to measure its performance in satisfying the same or similar performance obligations, otherwise that entity’s revenue would not be comparable in different reporting periods. The boards also noted that if an entity were permitted to apply more than one method to measure its performance in fulfilling a performance obligation, it would effectively bypass the requirements for identifying performance obligations.
- BC162 Although the boards did not consider all possible methods and prescribe when an entity should use each method, they observed that there are broadly two methods that the entity might consider when determining the method of measuring progress towards complete satisfaction of the performance obligation—that is, output and input methods. Requirements for the application of those methods are included in the application guidance (see paragraphs B14–B19 of IFRS 15).

Output methods

- BC163 Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for example, surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed and units delivered or units produced). When applying an output method, ‘value to the customer’ refers to an objective measure of the entity’s performance in the contract. However, value to the customer is not intended to be assessed by reference to the market prices or stand-alone selling prices of the individual goods or services promised in the contract, nor is it intended to refer to the value that the customer perceives to be embodied in the goods or services.
- BC164 The boards decided that, conceptually, an output measure is the most faithful depiction of an entity’s performance because it directly measures the value of the goods or services transferred to the customer. However, the boards observed that it would be appropriate for an entity to use an

input method if that method would be less costly and would provide a reasonable proxy for measuring progress.

- BC165 In the redeliberations, some respondents, particularly those in the contract manufacturing industry, requested the boards to provide more guidance on when units-of-delivery or units-of-production methods would be appropriate. Those respondents observed that such methods appear to be output methods and, therefore, questioned whether they would always provide the most appropriate depiction of an entity's performance. The boards observed that such methods may be appropriate in some cases; however, they may not always result in the best depiction of an entity's performance if the performance obligation is satisfied over time. This is because a units-of-delivery or a units-of-production method ignores the work in progress that belongs to the customer. When that work in progress is material to either the contract or the financial statements as a whole, the boards observed that using a units-of-delivery or a units-of-production method would distort the entity's performance because it would not recognise revenue for the assets that are created before delivery or before production is complete but are controlled by the customer.
- BC166 The boards also observed that a units-of-delivery or a units-of-production method may not be appropriate if the contract provides both design and production services because, in this case, each item produced or delivered may not transfer an equal amount of value to the customer. However, a units-of-delivery method may be an appropriate method for measuring progress for a long-term manufacturing contract of standard items that individually transfer an equal amount of value to the customer on delivery. Thus, the boards clarified that in selecting an output method for measuring progress and determining whether a units-of-delivery or a units-of-production method is appropriate, an entity should consider its facts and circumstances and select the method that depicts the entity's performance and the transfer of control of the goods or services to the customer.
- BC167 The boards also decided that, in some circumstances, as a practical expedient, another appropriate output method is to recognise revenue at the amount of consideration to which an entity has a right to invoice. This method is appropriate if the amount of consideration that the entity has a right to invoice corresponds directly with the value to the customer of each incremental good or service that the entity transfers to the customer (ie the entity's performance completed to date). This may occur, for example, in a services contract in which an entity invoices a fixed amount for each hour of service provided.

Input methods

- BC168 Input methods recognise revenue on the basis of an entity's efforts or inputs towards satisfying a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to satisfy the performance obligation.
- BC169 In some contracts, an entity promises to transfer both goods and services to a customer, but the customer takes control of the goods, which represent a significant part of the performance obligation, at a different time from that of the services (for example, the customer obtains control of the goods before they are installed). If those goods and services are not distinct, then the entity would have a single performance obligation. Because there is diversity in practice about how to apply an input method to measure progress in such situations, the boards decided to provide additional guidance related to uninstalled materials.

Uninstalled materials

- BC170 The boards decided to clarify that the adjustment to the input method for uninstalled materials is intended to ensure that the input method meets the objective of measuring progress towards complete satisfaction of a performance obligation, as described in paragraph 39 of IFRS 15—that is, to depict an entity's performance.
- BC171 The boards observed that if a customer obtains control of the goods before they are installed by an entity, then it would be inappropriate for the entity to continue to recognise the goods as inventory. Instead, the entity should recognise revenue for the transferred goods in accordance with the core principle of IFRS 15. The boards also observed that if the entity applies a cost-to-cost method of measuring progress (ie costs incurred compared with total expected costs), the entity might (in the

absence of clear requirements) include the cost of the goods in the cost-to-cost calculation and, therefore, recognise a contract-wide profit margin for the transfer of the goods. The boards noted that recognising a contract-wide profit margin before the goods are installed could overstate the measure of the entity's performance and, therefore, revenue would be overstated. Alternatively, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (thus bypassing the requirements for identifying performance obligations). Therefore, the boards decided that, in specified circumstances, an entity should recognise revenue for the transfer of the goods but only in an amount equal to the cost of those goods. In those circumstances, an entity should also exclude the costs of the goods from the cost-to-cost calculation to be consistent with the cost-to-cost methodology.

- BC172 The boards noted that the adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of goods in a construction-type contract—that is, only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a simple procurement service to the customer. For goods that meet the conditions in paragraph B19(b) of IFRS 15, recognising revenue to the extent of the costs of those goods ensures that the depiction of the entity's profit (or margin) in the contract is similar to the profit (or margin) that the entity would recognise if the customer had supplied those goods themselves for the entity to install or use in the construction activity.
- BC173 Some respondents disagreed with the requirements that an entity recognise a profit margin of zero on the transfer of the uninstalled materials to the customer. In their view, recognising different profit margins for different parts of a single performance obligation is inconsistent with the principle of identifying performance obligations. Other respondents disagreed with recognising revenue for uninstalled materials at a zero profit margin because it might not properly depict an entity's rights under the contract (for example, if the entity was entitled on termination of the contract to a payment at an amount that reflects the contract-wide margin for all work performed, including the transfer of uninstalled materials to the customer).
- BC174 The boards considered those arguments but decided that the adjustment to the input method specified in paragraph B19(b) of IFRS 15 will ensure that the input method meets the objective of measuring progress to depict an entity's performance. The boards disagreed with the concern raised by some respondents that paragraph B19(b) of IFRS 15 is inconsistent with the principle of identifying performance obligations. Although the outcome of applying paragraph B19(b) of IFRS 15 is that some goods or services that are part of a single performance obligation attract a margin, while any uninstalled materials attract only a zero margin, that difference arises only as a consequence of the need to adjust the cost-to-cost calculation so that the input method faithfully depicts the entity's performance in the contract.
- BC175 To be consistent with their decision on uninstalled materials, the boards also clarified that if an entity selects an input method such as cost-to-cost to measure its progress, the entity should adjust the measure of progress if including some of those costs incurred (for example, inefficiencies and wasted materials) would distort the entity's performance in the contract.

Inefficiencies and wasted materials

- BC176 Paragraph B19 of IFRS 15 acknowledges that a shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. This would be the case if the cost-to-cost method includes costs attributable to wasted materials or other inefficiencies that do not contribute to the satisfaction of a performance obligation. Consequently, an entity should exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer (for example, the costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract). In that regard, the requirements in paragraph B19 of IFRS 15 can be viewed as a reminder that a mechanical application of the cost-to-cost method might not always provide a faithful depiction of the entity's performance.
- BC177 As part of their redeliberations, the boards considered whether more guidance should be provided on the notions of inefficiency and wasted materials. For instance, some respondents asked if the assessment should focus on entity-specific inefficiencies or market-driven inefficiencies, and some requested a clear distinction between the accounting for normal expected wasted materials and the accounting for abnormal wasted materials.

- BC178 The boards acknowledged the concerns but decided that it would not be feasible to develop additional guidance that would clearly and consistently identify the costs of inefficiencies and wasted materials that should be excluded from a cost-to-cost measure of progress. Instead, the boards decided to emphasise that the objective of measuring progress towards complete satisfaction of the performance obligation is to depict an entity's performance in the contract and therefore a cost-to-cost calculation may require adjustment if some of the costs incurred do not contribute to the progress in the contract.

Reasonable measures of progress

- BC179 The boards clarified that when selecting a method to measure progress and, thus, determining when to recognise revenue, an entity should recognise revenue for its performance only if it can reasonably measure its progress towards complete satisfaction of the performance obligation. Some asked whether an entity's inability to measure progress would mean that costs would also be deferred. However, the boards observed that unless the entity can recognise an asset from the costs to fulfil a contract in accordance with paragraph 95 of IFRS 15, those costs would not represent an asset of the entity and, therefore, should be recognised as expenses as they are incurred.
- BC180 The boards also concluded that in cases in which an entity cannot reasonably measure its progress towards complete satisfaction of a performance obligation, but nevertheless expects eventually to recover the costs incurred in satisfying the performance obligation, the entity should recognise at least some amount of revenue to reflect the fact that it is making progress in satisfying the performance obligation. Consequently, the boards decided that in those cases, an entity should recognise revenue for the satisfaction of the performance obligation only to the extent of the costs incurred. (That method is consistent with previous revenue recognition requirements in both IFRS and US GAAP for measuring progress.) However, the boards also decided that an entity should stop using that method when it can reasonably measure its progress towards complete satisfaction of the performance obligation.

Measurement of revenue (paragraphs 46–90)

- BC181 The boards decided that an entity should measure revenue based on an allocated transaction price approach. Using that approach, an entity allocates the transaction price to each performance obligation at an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. That allocation determines the amount of revenue that an entity recognises when (or as) it satisfies each performance obligation. Most respondents supported the allocated transaction price approach.
- BC182 The boards considered, but rejected, an alternative measurement approach, which would have been to measure the remaining performance obligations directly at the end of each reporting period. The boards observed that this alternative would have made accounting for the contract more complex. In addition, the boards expected that in many cases it would have provided users of financial statements with little additional information, either because the values of goods or services promised are not inherently volatile or because the effect of any volatility that might exist is limited when an entity transfers the goods or services to the customer over a relatively short time. Paragraphs BC25–BC27 include additional discussion on rejected measurement approaches.
- BC183 The allocated transaction price approach generally requires an entity to follow three main steps to determine the amount of revenue that can be recognised for satisfied performance obligations. Those steps are as follows:
- (a) determine the transaction price for the contract;
 - (b) allocate the transaction price to performance obligations; and
 - (c) recognise revenue at the amount allocated to the satisfied performance obligation.

Determining the transaction price (paragraphs 47–72)

- BC184 Determining the transaction price is an important step in the revenue recognition model because the transaction price is the amount that an entity allocates to the performance obligations in a contract and ultimately recognises as revenue.
- BC185 The boards decided to define the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services. Consequently, the objective in determining the transaction price at the end of each reporting period is to predict the total amount of consideration to which the entity will be entitled from the contract. In developing IFRS 15, the boards decided that the transaction price should not be adjusted for the effects of the customer's credit risk (see paragraphs BC259–BC265) unless the contract includes a significant financing component (see paragraphs BC229–BC247).
- BC186 The boards clarified that the transaction price should include only amounts (including variable amounts) to which the entity has rights under the present contract. For example, the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders. Until the customer exercises the option or agrees to the change order, the entity does not have a right to consideration.
- BC187 The boards also clarified that the amounts to which the entity has rights under the present contract can be paid by any party (ie not only by the customer). For example, in the healthcare industry, an entity may determine the transaction price based on amounts to which it will be entitled to payment from the patient, insurance companies and/or governmental organisations. This may also occur in other industries in which an entity receives a payment from a manufacturer as a result of the manufacturer issuing coupons or rebates directly to the entity's customer. However, it would not include amounts collected on behalf of another party such as some sales taxes and value added taxes in some jurisdictions.
- BC188 Determining the transaction price when a customer promises to pay a fixed amount of cash consideration (ie an amount that will not vary) will be simple. However, determining the transaction price may be more difficult in the following cases:
- (a) the promised amount of consideration is variable (see paragraphs BC189–BC202), which will also require an entity to consider whether it should constrain the estimated amount of consideration to be included in the transaction price (see paragraphs BC203–BC223);
 - (b) the contract has a significant financing component (see paragraphs BC229–BC247);
 - (c) the promised amount of consideration is in a form other than cash (see paragraphs BC248–BC254); and
 - (d) there is consideration payable to the customer by the entity (see paragraphs BC255–BC258).

Clarifications to IFRS 15 (amendments issued in April 2016)—topics for which the IASB decided not to amend IFRS 15 (presentation of sales taxes)

- BC188A Paragraph 47 of IFRS 15 specifies that amounts collected on behalf of third parties, such as some sales taxes, are excluded from the determination of the transaction price. Entities are therefore required to identify and assess sales taxes to determine whether to include or exclude those taxes from the transaction price.
- BC188B After the issuance of Topic 606 and IFRS 15, some US stakeholders expressed concerns about the cost and complexity of assessing tax laws in each jurisdiction, because many entities operate in numerous jurisdictions, and the laws in some jurisdictions are unclear about which party to the transaction is primarily obligated for payment of the taxes. These stakeholders also stated that the variety of, and changes in, tax laws among jurisdictions contributes to that complexity. Consequently, some preparers and auditors asked the boards to amend the Standard to add a practical expedient to reduce the complexity and practical difficulties in assessing whether a sales tax is collected on behalf of a third party. An accounting policy choice to either include or exclude

all sales taxes in or from revenue was available in the previous revenue standards under US GAAP.

BC188C The FASB decided to amend Topic 606 to provide an accounting policy election that permits an entity to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on, and concurrent with, a specific revenue-producing transaction and collected from customers (for example, sales taxes, use taxes, value added taxes, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process are excluded from the scope of the election.

BC188D The IASB decided not to provide a similar accounting policy choice, for the following reasons:

- (a) It would reduce the comparability of revenue between entities operating under different tax regimes in different jurisdictions, as well as between entities operating in the same jurisdictions to the extent that they choose different approaches.
- (b) The previous revenue Standards under IFRS contained requirements applicable to sales tax similar to those in IFRS 15. Consequently, assessing whether sales taxes are collected on behalf of a third party is not a new requirement for IFRS preparers.
- (c) It would create an exception to the revenue recognition model that does not reflect the economics of the arrangement in cases for which a sales (or similar) tax is a tax on the entity rather than a tax collected by the entity from the customer on behalf of a tax authority.

The IASB acknowledged that, because the policy choice is not available in IFRS 15, this gives rise to a difference between IFRS 15 and Topic 606.

Variable consideration (paragraphs 50–59)

BC189 The boards noted that in contracts with customers in which the promised consideration is variable, an entity needs to estimate the amount of consideration to which the entity expects to be entitled. Consequently, the boards decided to provide requirements that address:

- (a) identifying when variable consideration is present in a contract with a customer (see paragraphs BC190–BC194);
- (b) the methods for estimating variable consideration (see paragraphs BC195–BC202);
- (c) when those estimates of variable consideration should be constrained and, thus, not included in the transaction price (see paragraphs BC203–BC223); and
- (d) how to account for subsequent changes in the transaction price (see paragraphs BC224–BC228).

Identifying variable consideration

BC190 The boards noted that variable consideration can arise in any circumstance in which the consideration to which the entity will be entitled under the contract may vary. The examples in paragraph 51 of IFRS 15 include common types of variable consideration that may occur in a contract with a customer.

BC191 The boards observed that consideration can be variable even in cases in which the stated price in the contract is fixed. This is because the entity may be entitled to the consideration only upon the occurrence or non-occurrence of a future event. Consider, for example, a fixed-price service contract in which the customer pays upfront and the terms of the contract provide the customer with a full refund of the amount paid if the customer is dissatisfied with the service at any time. In those cases, the consideration is variable because the entity might be entitled to all of the consideration or none of the consideration if the customer exercises its right to a refund.

- BC192 The contract will often specify the terms that result in the consideration being classified as variable. However, in some cases the promised consideration may be variable because the facts and circumstances indicate that the entity may accept a lower price than that stated in the contract (ie the contract contains an implicit price concession). The boards observed that an entity's customary business practices, published policies or specific statements may provide evidence that the entity is willing to accept a lower price in exchange for the promised goods and services. For example, an entity might grant a price concession to a customer for goods that were previously sold to that customer to enable the customer to discount the goods and, therefore, more easily sell them to a third party. The boards noted that in many cases, price concessions are likely to be granted to enhance a customer relationship to encourage future sales to that customer.
- BC193 The boards decided that an entity should also consider all facts and circumstances to determine whether the entity will accept a lower amount of consideration than the price stated in the contract. For example, an entity might enter into a contract with a new customer with a strategy to develop the customer relationship. In that case, although there may not be past evidence that the entity will provide a price concession, there may be other factors present that result in the entity concluding that it will accept a lower price than that stated in the contract.
- BC194 The boards observed that in some cases it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (ie customer credit risk). The boards noted that an entity should use judgement and consider all relevant facts and circumstances in making that determination. The boards observed that this judgement was being applied under previous revenue recognition requirements. Consequently, the boards decided not to develop detailed requirements for differentiating between a price concession and impairment losses.

The method for estimating the variable consideration

- BC195 The boards decided to specify that an entity should estimate variable consideration using either the expected value or the most likely amount, depending on which method the entity expects will better predict the amount of consideration to which the entity will be entitled (see paragraph 53 of IFRS 15). The boards noted that this is not intended to be a 'free choice'; an entity needs to consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.
- BC196 The boards concluded on the methods to estimate the transaction price in response to the feedback on the 2010 Exposure Draft. That exposure draft proposed that when the consideration in a contract is variable, an entity should measure the transaction price (at its expected value) using only a probability-weighted method. A probability-weighted method reflects the full range of possible consideration amounts, weighted by their respective probabilities. Many respondents to the 2010 Exposure Draft disagreed with measuring the transaction price using a probability-weighted method because they reasoned it would:
- (a) add complexity and be costly to apply; and
 - (b) impede the reporting of meaningful results in all circumstances because, for example, it could result in an entity determining the transaction price at an amount of consideration that the entity could never obtain under the contract.
- BC197 Some respondents suggested that the boards not specify a measurement model and, instead, require that the transaction price be determined using management's best estimate. Many noted that this would provide management with the flexibility to estimate on the basis of its experience and available information, without the documentation that would be required when a measurement model is specified.
- BC198 In their redeliberations, the boards reaffirmed their decision to specify an objective and an appropriate measurement method for estimating the transaction price. This is because specifying an objective and an appropriate measurement method would provide the necessary framework to ensure rigour in the process of estimation. Furthermore, without such a framework, the measurement of revenue might not be understandable to users of financial statements and might lack comparability between entities.

- BC199 However, in their redeliberations, the boards reconsidered what the appropriate measurement method(s) should be. They noted that a probability-weighted method reflects all of the uncertainties existing in the transaction price at the end of the reporting period. Therefore, it best reflects the conditions that are present at the end of each reporting period. For instance, it reflects the possibility of receiving a greater amount of consideration as well as the risk of receiving a lesser amount. However, the boards observed that users of financial statements are most interested in knowing the total amount of consideration that will ultimately be realised from the contract. Consequently, the boards decided that for the estimate of the transaction price to be meaningful at the end of each reporting period, it should be an amount that the entity expects to better predict the amount of consideration to which it will be entitled (the boards decided to address the issue of credit risk separately—see paragraphs BC259–BC265).
- BC200 The boards observed that in some cases, a probability-weighted estimate (ie an expected value) predicts the amount of consideration to which an entity will be entitled. For example, that is likely to be the case if the entity has a large number of contracts with similar characteristics. However, the boards agreed with respondents that an expected value may not always faithfully predict the consideration to which an entity will be entitled. For example, if the entity is certain to receive one of only two possible consideration amounts in a single contract, the expected value would not be a possible outcome in accordance with the contract and, therefore, might not be relevant in predicting the amount of consideration to which the entity will be entitled. The boards decided that in those cases, another method—the most likely amount method—is necessary to estimate the transaction price. This is because the most likely amount method identifies the individual amount of consideration in the range of possible consideration amounts that is more likely to occur than any other individual outcome.
- BC201 Theoretically, although an entity using the most likely amount method must consider all possible outcomes to identify the most likely one, in practice, there is no need to quantify the less probable outcomes. Similarly, in practice, estimating the expected value using a probability-weighted method does not require an entity to consider all possible outcomes using complex models and techniques, even if an entity has extensive data and can identify many outcomes. In many cases, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes. Therefore, the boards decided that neither of the two approaches should be too costly or complex to apply.
- BC202 The boards also decided that, to provide better information to users, an entity should apply one method consistently throughout the contract when estimating the effect of an uncertainty on the amount of variable consideration to which the entity expects to be entitled. However, the boards observed that this would not mean an entity would need to use one method to measure each uncertainty in a single contract. Instead, an entity may use different methods for different uncertainties.

Constraining estimates of variable consideration

- BC203 The boards decided that to provide useful information to users of financial statements, some estimates of variable consideration should not be included in the transaction price. This would be the case if the estimate of variable consideration (and consequently the amount of revenue recognised) is too uncertain and, therefore, may not faithfully depict the consideration to which the entity will be entitled in exchange for the goods or services transferred to the customer. In that case, the boards decided that an entity should constrain the estimate of variable consideration to be included in the transaction price.
- BC204 Many respondents agreed that it was necessary to include some form of constraint on the recognition of revenue that results from variable consideration because a significant portion of errors in financial statements under previous revenue recognition requirements have related to the overstatement or premature recognition of revenue. However, the boards noted that their intention was not to eliminate the use of estimates, which are commonplace and necessary in financial reporting, but instead to ensure that those estimates are robust and result in useful information. This is because revenue is an important metric and users of financial statements explained that it is critical that those estimates of variable consideration be included in revenue only when there is a high degree of confidence that revenue will not be reversed in a subsequent reporting period.
- BC205 In developing the requirements for constraining estimates of variable consideration, the boards considered the following:

- (a) the objective of constraining estimates of variable consideration and specifying a level of confidence (see paragraphs BC206–BC213);
- (b) application of the requirements for constraining estimates of variable consideration and sales-based and usage-based royalties on licences of intellectual property (see paragraphs BC214–BC219); and
- (c) whether the requirements for constraining estimates of variable consideration should be included in the determination of the transaction price (Step 3 of the revenue recognition model) or the determination of the cumulative amount of revenue recognised when a performance obligation is satisfied (Step 5 of the revenue recognition model) (see paragraphs BC220–BC223).

The objective of constraining estimates of variable consideration and specifying a level of confidence

- BC206 In their redeliberations, the boards decided that it would be helpful to clarify the objective for constraining estimates of variable consideration. In making their decision, the boards considered the feedback received from users of financial statements. The majority of users of financial statements that were consulted indicated that the most relevant measure for revenue in a reporting period would be one that will not result in a significant reversal in a subsequent period. This is because an amount that would not reverse in the future would help users of financial statements better predict future revenues of an entity. Therefore, the boards decided that the focus for constraining revenue should be on possible downward adjustments (ie revenue reversals), rather than on all revenue adjustments (ie both downward and upward adjustments). Specifically, the boards decided that an entity should include some or all of an estimate of variable consideration in the transaction price only to the extent it is highly probable that a significant revenue reversal will not occur.
- BC207 The boards acknowledge that the requirement to constrain estimates of variable consideration and the objective they have defined creates a tension with the notion of neutrality in the boards' respective conceptual frameworks. This is because the boards' decision introduces a downward bias into estimates that will be included in the transaction price. However, the boards decided that this bias was reasonable because users of financial statements indicated that revenue is more relevant if it is not expected to be subject to significant future reversals.
- BC208 In the redeliberations, preparers and auditors indicated that meeting the objective of constraining estimates of variable consideration would be difficult if no level of confidence was specified, for instance, if the boards merely specified that an entity should include variable consideration to the extent that it expects that doing so would not result in a significant revenue reversal. Many also observed that omitting a level of confidence from the objective could result in diversity in practice if entities interpreted the implicit confidence level in different ways (for example, some might interpret the implicit confidence level as virtually certain while others might presume it to mean more likely than not).
- BC209 Consequently, the boards decided that specifying a level of confidence would provide clarity and thus ensure more consistent application of the requirements to constrain estimates of variable consideration. In determining the appropriate level of confidence, the boards considered whether they could use the proposal in the 2011 Exposure Draft that constrained revenue to the amount to which an entity would be reasonably assured to be entitled. However, many respondents to the 2011 Exposure Draft were unsure about what the boards intended by using the term 'reasonably assured'. Those respondents observed that the term is used elsewhere in IFRS, US GAAP and auditing requirements and further noted that its meaning is often interpreted differently in those contexts.
- BC210 The boards also considered using terminology that has not previously been used in IFRS and US GAAP. However, the boards decided that any new term that was used might result in diversity in practice, because entities might interpret the new term in different ways. Consequently, the boards decided that the most appropriate level of confidence would be 'highly probable' for IFRS and 'probable' for US GAAP as a result of the usage of those terms in existing requirements.

- BC211 The boards observed that the term 'probable' is widely used and understood in practice in the United States and is defined in US GAAP as 'the future event or events are likely to occur' (Topic 450). In contrast, the term 'probable' is defined in IFRS as 'more likely than not' (IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). Therefore, to achieve the same meaning in IFRS as US GAAP, the boards decided to use the term 'highly probable' for IFRS purposes and 'probable' for US GAAP purposes. The boards noted that this is consistent with the approach that the IASB adopted in developing IFRS 5, for which the IASB used the term 'highly probable' to achieve the same meaning as 'probable' in US GAAP (see paragraph BC81 of IFRS 5).
- BC212 The boards observed that the analysis an entity would undertake to determine if its estimate met the required level of confidence would still be largely qualitative. Specifically, that analysis would require the entity to use judgement and consider the factors in paragraph 57 of IFRS 15 to assess whether it was highly probable that a significant revenue reversal would not occur. In other words, the boards did not expect that an entity would need to prepare a quantitative analysis each time it assessed the likelihood of whether a significant revenue reversal could occur. Therefore, the boards concluded that including a confidence level would not result in application of the requirements that is too costly or complex.
- BC213 The factors in paragraph 57 of IFRS 15 were derived in part from previous requirements in US GAAP on estimating sales returns. Those indicators were also proposed in the 2010 and the 2011 Exposure Drafts and respondents generally agreed that the indicators were relevant and helpful. In their redeliberations, the boards also decided to add an indicator in paragraph 57(d) of IFRS 15 to address the circumstances in which there is no explicit requirement to adjust the price stated in the contract, but the entity has a past practice of offering a broad range of price concessions (or similar types of price adjustments). This is because the boards observed that a practice of offering a broad range of price concessions would increase the probability that a significant revenue reversal would occur if the entity included the contractual amount of consideration in the transaction price.

Application of the requirements to constrain estimates of variable consideration

- BC214 The requirements for constraining estimates of variable consideration first require an entity to estimate the consideration to which the entity will be entitled (see paragraph 53 of IFRS 15). The entity then assesses whether the objective of the requirements for constraining estimates of variable consideration can be met—that is by determining whether it is highly probable that a significant revenue reversal will not occur when the uncertainty associated with the variable consideration is subsequently resolved. If the entity determines that it is highly probable that the inclusion of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price.
- BC215 Although some respondents explained that they reasoned that these requirements would inappropriately require a two-step process, the boards observed that an entity would not be required to strictly follow those two steps if the entity's process for estimating variable consideration already incorporates the principles on which the requirements for constraining estimates of variable consideration are based. For example, an entity might estimate revenue from sales of goods with a right of return. In that case, the entity might not practically need to estimate the expected revenue and then apply the constraint requirements to that estimate, if the entity's calculation of the estimated revenue incorporates the entity's expectations of returns at a level at which it is highly probable that the cumulative amount of revenue recognised would not result in a significant revenue reversal.
- BC216 The requirements for constraining estimates of variable consideration require an entity to assess whether a significant revenue reversal would not occur for the amount of cumulative revenue recognised for a satisfied (or partially satisfied) performance obligation. This is because the boards did not intend for an entity to inappropriately recognise revenue by offsetting the risk of a future revenue reversal for a satisfied (or partially satisfied) performance obligation against expected revenue from future performance.
- BC217 The requirements for constraining estimates of variable consideration also require an entity to assess the magnitude of a significant revenue reversal for both variable consideration and fixed consideration. For example, if the consideration for a single performance obligation included a fixed amount and a variable amount, the entity would assess the magnitude of a possible revenue reversal of the variable amount relative to the total consideration (ie variable and fixed

consideration). This is because the objective of constraining estimates of variable consideration is focused on a possible revenue reversal of the amount of cumulative revenue recognised for a performance obligation, rather than on a reversal of only the variable consideration allocated to that performance obligation.

- BC218 The boards noted that in some cases, when an entity applies the requirements for constraining estimates of variable consideration, the entity might determine that it should not include the entire estimate of the variable consideration in the transaction price when it is not highly probable that doing so would not result in a significant revenue reversal. However, the entity might determine that it is highly probable that including some of the estimate of the variable consideration in the transaction price would not result in a significant revenue reversal. The boards decided that, in such cases, the entity should include that amount in the estimate of the transaction price. Respondents to both the 2010 and the 2011 Exposure Drafts supported including some of the variable consideration in the transaction price (and therefore recognising that portion as revenue when the entity satisfies the related performance obligation) if including that amount would meet the objective of the requirements for constraining estimates of variable consideration.
- BC219 However, the boards decided that for a licence of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognise any revenue for the uncertain amounts until the uncertainty is resolved (ie when the customer's subsequent sales or usage occurs). The boards included these requirements because both users and preparers of financial statements generally indicated that if an entity recognised a minimum amount of revenue for those contracts it would not provide relevant information (see paragraphs BC419–BC421).

Constraining the estimate of the transaction price (Step 3) or constraining the cumulative amount of revenue that is recognised (Step 5)

- BC220 During the development of the requirements for constraining estimates of variable consideration, the boards considered where in the revenue recognition model it would be most appropriate to apply those requirements.
- BC221 Some respondents suggested that if the objective is to constrain the measurement of revenue, it might be more appropriate to constrain the transaction price (ie include a constraint at Step 3). In contrast, if the objective is to limit the amount of revenue recognised, it might be more appropriate to constrain the cumulative amount of revenue recognised (ie include a constraint at Step 5). However, the boards observed that those are not truly independent objectives because the measurement of revenue determines the amount of revenue recognised. In other words, the requirements for constraining estimates of variable consideration restrict revenue recognition and use measurement uncertainty as the basis for determining if (or how much) revenue should be recognised. The boards noted that applying the requirements for constraining estimates of variable consideration to the transaction price or to the cumulative amount of revenue recognised should have an equal effect on the amount of revenue recognised in a contract.
- BC222 Consequently, the boards decided that the requirements for constraining estimates of variable consideration should be incorporated into the determination of the transaction price because feedback from respondents indicated that this would be consistent with the way in which management often considers variable consideration.
- BC223 Respondents in the asset management and hotel management industries questioned whether constraining the transaction price would result in a pattern of revenue recognition that would faithfully depict their performance under the contract. In many of the contracts in those industries, when a portion of the variable consideration becomes fixed, it relates only to the performance for the period. The boards observed that the requirements for allocating variable consideration (see paragraphs BC284–BC293) would ensure that the revenue recognised would faithfully depict the performance in such a contract.

Subsequent changes in the transaction price

- BC224 After contract inception, an entity will revise its expectations about the amount of consideration to which it expects to be entitled as uncertainties are resolved or as new information about remaining uncertainties becomes available. To depict conditions that exist at the end of each reporting period

(and changes in conditions during the reporting period), the boards decided that an entity should update its estimate of the transaction price throughout the contract. The boards concluded that reflecting current assessments of the amount of consideration to which the entity expects to be entitled will provide more useful information to users of financial statements than retaining the initial estimates, especially for long-term contracts that are subject to significant changes in conditions during the life of the contract.

BC225 The boards considered whether an entity should do either of the following if the transaction price changes during a contract:

- (a) recognise those changes in profit or loss when the changes occur; or
- (b) allocate those changes to performance obligations.

BC226 The boards rejected the alternative of recognising the entire amount of a change in the estimate of the transaction price in profit or loss when that change occurs. In the boards' view, that alternative could have resulted in a pattern of revenue recognition that would not faithfully depict the pattern of the transfer of goods or services. Moreover, recognising revenue immediately (and entirely) for a change in the estimate of the transaction price would have been prone to abuse in practice. The boards considered whether changes in the estimate of the transaction price could be presented as a gain or loss separately from revenue, thus preserving the pattern of revenue recognition. However, the boards rejected that alternative because the total amount of revenue recognised for the contract would not have equalled the amount of consideration to which the entity was entitled under the contract.

BC227 Instead, the boards decided that an entity should allocate a change in the transaction price to all the performance obligations in the contract, subject to the conditions in paragraphs 87–90 of IFRS 15 (see paragraph BC286). This is because the cumulative revenue recognised will then depict the revenue that the entity would have recognised at the end of the subsequent reporting period, if the entity had the information at contract inception. Consequently, the transaction price that is allocated to performance obligations that have already been satisfied should be recognised as revenue (or as a reduction of revenue) immediately.

BC228 The boards noted that in some cases, an entity might make an estimate of the amount of variable consideration to include in the transaction price at the end of a reporting period. However, information relating to the variable consideration might arise between the end of the reporting period and the date when the financial statements are authorised for issue. The boards decided not to provide guidance on the accounting in these situations because they noted that the accounting for subsequent events is already addressed in IAS 10 *Events after the Reporting Period* and Topic 855 *Subsequent Events*.

The existence of a significant financing component in the contract (paragraphs 60–65)

BC229 Some contracts with customers include a financing component. The financing component may be explicitly identified in the contract or may be implied by the contractual payment terms of the contract. A contract that has a financing component includes, conceptually, two transactions—one for the sale and one for the financing. The boards decided to require an entity to adjust the promised amount of consideration for the effects of financing components if those financing components are significant, for the following reasons:

- (a) not recognising a financing component could misrepresent the revenue of a contract. For example, if a customer pays in arrears, ignoring the financing component of the contract would result in full revenue recognition on the transfer of the good or service, despite the fact that the entity is providing a service of financing to the customer.
- (b) in some contracts, entities (or customers) consider the timing of the cash flows in a contract. Consequently, identifying a significant financing component acknowledges an important economic feature of the contract, which is that the contract includes a financing arrangement as well as the transfer of goods or services. A contract in which the customer pays for a good or service when that good or service is transferred to the customer may be significantly different from a contract in which the customer pays before

or after the good or service is transferred in order to provide or receive a financing benefit.

- BC230 The objective of adjusting the promised amount of consideration for the effects of a significant financing component is to reflect, in the amount of revenue recognised, the 'cash selling price' of the underlying good or service at the time that the good or service is transferred. The boards observed that adjusting the promised consideration to obtain the cash selling price may only be required when the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. This is because, in other cases, the timing of payments may be for a purpose other than financing, such as protection for non-performance. This is described further in the following paragraphs.

Determining whether a contract includes a significant financing component

- BC231 The boards considered whether the requirements for identifying a financing component should be based only on whether payment is due either significantly before, or significantly after, the transfer of goods or services to the customer. However, a number of respondents explained that this might have required an entity to adjust for the time value of money when the parties did not contemplate a financing arrangement as part of the negotiated terms of the contract. Those respondents explained that, in some cases, although there is a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference is not related to a financing arrangement between the entity and the customer. The boards agreed with those respondents and clarified their intention by specifying in paragraph 60 of IFRS 15 that an entity should adjust for financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.
- BC232 The boards also decided to remove the term 'time value of money' from the discussion about adjustments for financing components, to reflect their decision that the focus is on whether the payment terms provide the customer or the entity with a significant benefit of financing. This is because the term 'time value of money' is a broader economic term that may suggest that it is necessary to adjust the promised amount of consideration in circumstances other than when the cash sales price may differ from the contractual payments. In addition, the boards decided to refine the factors in paragraph 61 of IFRS 15 that an entity should consider when deciding whether a contract includes a significant financing component. Those factors require evaluation of:
- (a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services. If the entity (or another entity) sells the same good or service for a different amount of consideration depending on the timing of the payment terms, this generally provides observable data that the parties are aware that there is a financing component in the contract. This factor is presented as an indicator because in some cases the difference between the cash selling price and the consideration promised by the customer is due to factors other than financing (see paragraph BC233).
 - (b) the combined effect of (1) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services and (2) the prevailing interest rates in the relevant market. Although the boards decided that the difference in timing between the transfer of goods and services and payment for those goods and services is not determinative, the combined effect of timing and the prevailing interest rates may provide a strong indication that a significant benefit of financing is being provided.
- BC233 In addition, the boards included criteria in paragraph 62 of IFRS 15 to clarify the circumstances in which a contract does *not* provide the customer or the entity with a significant benefit of financing:
- (a) the customer has paid for the goods or services in advance and, the timing of the transfer of those goods or services is at the discretion of the customer. The boards noted that for some types of goods or services, such as prepaid phone cards and customer loyalty points, the customer will pay for those goods or services in advance and the transfer of those goods or services to the customer is at the customer's discretion. The boards expected that, in those cases, the purpose of the payment terms is not related to a financing arrangement between the parties. In addition, the boards decided that the costs

of requiring an entity to account for the time value of money in these cases would outweigh any perceived benefit because the entity would need to continually estimate when the goods or services will transfer to the customer.

- (b) a substantial amount of the consideration promised by the customer is variable and that consideration varies on the basis of factors that are outside the control of the customer or the entity. The boards observed that for some arrangements, the primary purpose of the specified timing or amount of the payment terms might not be to provide the customer or the entity with a significant benefit of financing but, instead, to resolve uncertainties that relate to the consideration for the goods or services. For example, in a royalty arrangement, the entity and the customer might not be willing to fix the price and timing of payment because there are significant uncertainties about the goods or services. The primary purpose of those payment terms may be to provide the parties with assurance of the value of the goods or services rather than to provide significant financing to the customer.
- (c) the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity. In some circumstances, a payment in advance or in arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing. For example, a customer may retain or withhold some consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. Alternatively, the customer might be required to pay some consideration upfront to secure a future supply of limited goods or services. The primary purpose of those payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, rather than to provide financing to the customer or the entity respectively.

BC234 The boards also observed that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognised in relation to a contract with a customer. In other words, for those contracts, the financing component will not be significant. During their redeliberations, the boards clarified that an entity should consider only the *significance* of a financing component at a contract level rather than consider whether the financing is *material* at a portfolio level. The boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

Practical reliefs from the significant financing component requirements

BC235 Some previous requirements required an entity to recognise the effects of a significant financing component with a customer only if the time period exceeded a specified period, often one year. For example, Subtopic 835-30 *Interest—Imputation of Interest*, excluded ‘transactions with customers or suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year’. The boards decided to include similar relief in IFRS 15 from the requirements to account for a significant financing component in circumstances in which the period between when the entity transfers the promised goods or services to the customer, and when the customer pays for those goods or services, is one year or less (see paragraph 63 of IFRS 15). The boards observed that, as with the other practical expedients in IFRS 15, an entity should apply the practical expedient consistently to similar contracts in similar circumstances.

BC236 The boards acknowledged that the relief could produce arbitrary outcomes in some cases because the financing component could be material for short-term contracts with high implicit interest rates and, conversely, could be immaterial for long-term contracts with low implicit interest rates. However, the boards decided to exempt an entity from accounting for the effects of any significant financing component on contracts with an expected duration of one year or less for the following reasons:

- (a) application of IFRS 15 would be simplified. This is because an entity would not be required to:

- (i) conclude whether those contracts contain the attributes of a financing component that are significant to those contracts (see paragraph BC232); and
 - (ii) determine the interest rate that is implicit within those contracts.
 - (b) the effect on the pattern of profit recognition should be limited because the exemption would apply only to financing arrangements that are expected to expire within 12 months (ie when either the customer pays or the entity performs).
- BC237 Some respondents also suggested that the boards should exempt an entity from reflecting in the measurement of the transaction price the effect of a significant financing component associated with advance payments from customers. Those respondents commented that accounting for any effects of a significant financing component arising from advance payments would result in the following:
- (a) change previous practices in which entities typically did not recognise the effects of the financing implicit in advance payments;
 - (b) revenue that is higher than the cash received (for example, if the discount rate implicit in the contract resulted in the accretion of interest of CU21⁴ over two years, revenue would be recognised in the amount of the CU121 rather than the CU100 in cash that was paid in advance); and
 - (c) not reflect the economics of the arrangement when the customer pays in advance for reasons other than financing (for example, the customer has significant credit risk or is compensating the entity for incurring upfront contract costs).
- BC238 The boards decided not to exempt an entity from accounting for the effects of a significant financing component for advance payments. This is because ignoring the effects of advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is significant and the primary purpose of that payment is to provide financing to the entity. Consider the example in which an entity requires a customer to pay in advance for a long-term construction contract, because the entity requires financing to obtain materials for the contract. If the entity did not require the customer to pay in advance, the entity would need to obtain the financing from a third party and, consequently, would charge the customer a relatively higher amount to cover the finance costs incurred. However, in either scenario the goods or services transferred to the customer are the same; it is only the party providing the financing to the entity that changes. Consequently, the entity's revenue should be consistent regardless of whether it receives the significant financing benefit from the customer or from a third party.

Discount rate

- BC239 The boards considered whether the discount rate used to adjust the promised amount of consideration for the effects of a significant financing component should be a risk-free rate or a risk-adjusted rate. A risk-free rate would have been observable and simple to apply in many jurisdictions and it would have avoided the costs of determining a rate specific to each contract. However, the boards decided that using a risk-free rate would not result in useful information, because the resulting interest rate would not have reflected the characteristics of the parties to the contract. In addition, the boards noted that it would not necessarily have been appropriate to use any rate explicitly specified in the contract because the entity might offer 'cheap' financing as a marketing incentive and, therefore, using that rate would not have resulted in an appropriate recognition of profit over the life of the contract. Consequently, the boards decided that an entity should apply the rate used in a financing transaction between the entity and its customer that does not involve the provision of goods or services because that rate reflects the characteristics of the party receiving financing in the contract. That rate also reflects the customer's creditworthiness, among other risks.

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Monetary items in the Basis for Conclusions are denominated as 'currency units' (CU).

- BC240 Some respondents mentioned that determining the discount rate that would be used in a separate financing transaction between an entity and a customer would be difficult and costly because most entities within the scope of IFRS 15 do not enter into separate financing transactions with their customers. In addition, it would have been impractical for entities with large volumes of customer contracts to determine a discount rate specifically for each individual customer.
- BC241 The boards addressed many of those concerns by providing both the exemption for contracts with a term of up to one year from being considered to have a significant financing component and the factors in paragraph 62 of IFRS 15, which describe when there is no significant financing component that needs to be accounted for. The boards expect that in those remaining contracts in which an entity is required to account separately for the financing component, the entity and its customer will typically negotiate the contractual payment terms separately after considering factors such as inflation rates and the customer's credit risk. Therefore, an entity should have access to sufficient information to determine the discount rate that would be used in a separate financing between the entity and the customer.

Re-evaluating the discount rate used for a significant financing component

- BC242 Some respondents asked whether an entity would be required to revise the discount rate used in determining the amount of a significant financing component if there was a change in circumstances.
- BC243 The boards clarified that an entity should not update the discount rate for a change in circumstances because an entity should reflect in the measurement of the transaction price only the discount rate that is determined at contract inception. They also observed that it would be impractical for an entity to update the transaction price for changes in the assessment of the discount rate.

Presentation of the effect of a significant financing component

- BC244 As a result of the boards' decision on the existence of a significant financing component (see paragraphs BC229–BC243), a contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred or advance payment terms). Consequently, the accounting for a trade receivable arising from a contract that has a significant financing component should be comparable to the accounting for a loan with the same features. Consider the following example: Customer A purchases a good on credit and promises to pay CU1,000 in three years. The present value of this trade receivable is CU751. Now consider Customer B who borrows CU751 from a bank with a promise to pay CU1,000 in three years. Customer B uses the loan to purchase the same good as Customer A. Economically, those transactions are the same, but, in the absence of the requirements in IFRS 15 to account for a significant financing component, the form of the transaction would determine whether an entity would recognise revenue of CU751 or CU1,000 (ie on a discounted or an undiscounted basis). For this reason, paragraphs 60–65 of IFRS 15 require a contract with a financing component that is significant to the contract to be separated, which results in the same revenue recognition for both transactions.
- BC245 The boards observed that the presentation, in the statement of comprehensive income, of any impairment losses from long-term trade receivables (ie receivables arising from the financing components of contracts with customers) would be consistent with the presentation of impairment losses for other types of financial assets within the scope of the boards' respective financial instruments Standards. The boards decided that impairment losses on short-term trade receivables (ie receivables arising from contracts with customers that do not have separately identified financing components) should be presented in the statement of comprehensive income in a consistent manner with impairment losses on long-term trade receivables (see paragraphs BC259–BC265).
- BC246 The boards decided that an entity should present the effect of the financing (ie the unwinding of the discount) separately from revenue from contracts with customers, as interest revenue or interest expense, rather than as a change to the measurement of revenue. This is because contracts with financing components that are significant have distinct economic characteristics—one relating to the transfer of goods or services to the customer and one relating to a financing arrangement—and those characteristics should be accounted for and presented separately.

- BC247 The boards noted that some entities (for example, banks and other entities with similar types of operations) regularly enter into financing transactions and, therefore, interest represents income arising from ordinary activities for those entities. The boards noted that the requirements in paragraph 65 of IFRS 15 do not preclude an entity from presenting interest as a type of revenue in circumstances in which the interest represents income from the entity's ordinary activities.

Non-cash consideration (paragraphs 66–69)

- BC248 When an entity receives cash from a customer in exchange for a good or service, the transaction price and, therefore, the amount of revenue, should be the amount of cash received (ie the value of the inbound asset). To be consistent with that approach, the boards decided that an entity should measure non-cash consideration at fair value. The non-cash consideration could be in the form of goods or services, but it may also be in the form of a financial instrument or property, plant and equipment. For example, an entity might receive an electrical substation in exchange for connecting houses in a new residential development to the electricity network.
- BC249 The boards decided that if an entity cannot reasonably estimate the fair value of the non-cash consideration, it should measure the promised consideration indirectly by reference to the stand-alone selling price of the goods or services promised in exchange for the consideration. That approach is consistent both with requirements in previous revenue Standards in IFRS and with requirements for other situations in which the fair value of the assets surrendered in exchange for assets received may be estimated more reliably. (For instance, IFRS 2 *Share-based Payment* and Subtopic 505-50 *Equity-Based Payments to Non-Employees* state that if the fair value of the goods or services received cannot be estimated reliably, then the entity measures them indirectly by reference to the fair value of the granted equity instrument.)
- BC250 Some respondents observed that estimates of fair value of non-cash consideration may vary like other types of variable consideration that the entity will receive in cash. For example, an entity's entitlement to a bonus that will be received in non-cash consideration may also depend on the occurrence or non-occurrence of a future event. Consequently, those respondents asked the boards to clarify whether the requirements for constraining estimates of variable consideration (see paragraphs 56–58 of IFRS 15) should be applied to estimates of the fair value of non-cash consideration.
- BC251 The boards observed that while the fair value of the non-cash consideration could change because of the occurrence or non-occurrence of a future event, it could also vary because of the form of the consideration. That is, the fair value could vary because of changes in the price or value of the non-cash consideration, such as a change in the price per share.
- BC252 The boards decided that it would be most appropriate to apply the requirements for constraining estimates of variable consideration to the same types of variability regardless of whether the amount that will be received will be in the form of cash or non-cash consideration. Consequently, the boards decided to constrain variability in the estimate of the fair value of the non-cash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration (ie for reasons other than changes in the price of the non-cash consideration). For example, if an entity is entitled to a performance bonus that is payable in the form of non-cash consideration, the entity would apply the requirements for constraining estimates of variable consideration to the uncertainty of whether the entity will receive the bonus, because that uncertainty is related to something other than the form of the consideration (ie the entity's performance). The boards observed that this principle is not that different from previous revenue recognition requirements under US GAAP for changes in the fair value of equity instruments that are granted as consideration in exchange for goods or services, although those requirements differentiated between the variability on the basis of performance conditions and market conditions (which were defined terms in those requirements).
- BC253 The boards also observed that once recognised, any asset arising from the non-cash consideration would be measured and accounted for in accordance with other relevant requirements (for example, IFRS 9 or Topic 320 *Investments—Debt and Equity Securities* or Topic 323 *Equity Method And Joint Ventures*).

BC254 The FASB noted that the requirements in Topic 606 will result in the removal of previous requirements for the accounting for share-based payments received by an entity in exchange for goods or services. Those previous requirements provided detailed guidance for the measurement and recognition of revenue when the consideration was in the form of shares or share options. However, the FASB decided to remove those requirements because equity instruments are merely another form of non-cash consideration. Therefore, equity instruments received as promised consideration in a contract with a customer would be accounted for consistently with other forms of non-cash consideration.

Clarifications to IFRS 15 (amendments issued in April 2016)—topics for which the IASB decided not to amend IFRS 15

BC254A The TRG discussed the following implementation questions raised by stakeholders in connection with applying IFRS 15 to contracts that involve non-cash consideration:

- (a) At which date should the fair value of non-cash consideration be measured in determining the transaction price?
- (b) How should the constraint on variable consideration be applied to transactions for which the fair value of non-cash consideration might vary due to both the form of the consideration and for other reasons?

Date of measurement of non-cash consideration

BC254B Paragraph 66 of IFRS 15 requires non-cash consideration to be measured at fair value (or by reference to the stand-alone selling price of the goods or services promised to the customer if an entity cannot reasonably estimate fair value of the non-cash consideration). The TRG's discussion informed the boards that the measurement date for non-cash consideration is unclear and could be interpreted as one of several dates: (a) at contract inception; (b) when the non-cash consideration is received; or (c) at the earlier of when the non-cash consideration is received and when the related performance obligation is satisfied.

BC254C In its discussions, the IASB observed that this issue has important interactions with other Standards (including IFRS 2 *Share-based Payment* and IAS 21 *The Effects of Changes in Foreign Exchange Rates*) and, thus, any decisions made would create a risk of potential unintended consequences. Accordingly, the IASB decided that, if needed, issues relating to the measurement of non-cash consideration should be considered more comprehensively in a separate project.

BC254D The FASB decided to amend the guidance in Topic 606 to require non-cash consideration to be measured at its fair value at contract inception. In the FASB's view, measuring non-cash consideration at contract inception is most consistent with the requirements in Topic 606 on determining the transaction price and on allocating the transaction price to performance obligations. The FASB also expects this approach to be typically less costly and less complex to apply in practice than other alternatives.

BC254E The IASB acknowledged that, because it has concluded that a change equivalent to that decided by the FASB is not needed, the use of a measurement date other than contract inception would not be precluded under IFRS. Consequently, it is possible that diversity between IFRS and US GAAP entities could arise in practice. The IASB observed that, unlike US GAAP, existing IFRS does not contain any specific requirements about the measurement date for non-cash consideration for revenue transactions. In addition, discussions with some stakeholders highlighted that any practical effect of different measurement dates would arise in only limited circumstances. The IASB also noted that paragraph 126 of IFRS 15 requires an entity to disclose information about the methods, inputs and assumptions used for measuring non-cash consideration.

Application of the variable consideration constraint to changes in fair value of non-cash consideration

BC254F The TRG discussed the concerns raised by some stakeholders that it is not clear whether the variable consideration requirements in paragraphs 56–58 of IFRS 15 apply in circumstances in which the fair value of non-cash consideration varies due to both the form of the consideration and

for other reasons. In particular, some stakeholders are concerned that bifurcating the effects of variability might be challenging in some circumstances.

BC254G The FASB decided to amend Topic 606 to specify that the constraint on variable consideration applies only to variability that arises for reasons other than the form of the consideration. Paragraph 68 of IFRS 15 indicates that the requirements for constraining estimates of variable consideration are applied if the fair value of the non-cash consideration promised by a customer varies for reasons other than only the form of the consideration (for example, a change in the exercise price of a share option because of the entity's performance). The FASB observed that applying the variable consideration requirements to both types of variability might not provide users of financial statements with useful information, because the timing of revenue recognition might differ for similar transactions settled in different forms of consideration (for example, cash and shares). Additionally, the inclusion of a minor performance condition could significantly affect the amount of non-cash consideration that would be subject to the constraint on variable consideration.

BC254H The IASB noted that paragraph BC252 explains that the boards decided to constrain variability in the estimate of the fair value of the non-cash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration (ie for reasons other than changes in the price of the non-cash consideration). The IASB also noted the view of some TRG members that in practice it might be difficult to distinguish between variability in the fair value due to the form of the consideration and other reasons, in which case applying the variable consideration constraint to the whole of the estimate of the non-cash consideration might be more practical. However, for reasons similar to those discussed in paragraph BC254E, the IASB decided not to amend IFRS 15 for this issue. Consequently, the IASB acknowledged that differences may arise between an entity reporting under IFRS and an entity reporting under US GAAP.

Consideration payable to a customer (paragraphs 70–72)

BC255 In some cases, an entity pays consideration to one of its customers or to its customer's customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay a customer of that dealer or distributor). That consideration might be in the form of a payment in exchange for goods or services received from the customer, a discount or refund for goods or services provided to the customer, or a combination of both.

BC256 To help an entity distinguish between those types of payments, the boards decided that the only circumstance in which an entity should account for any good or service received in the same way as for other purchases from suppliers is if the good or service is distinct. Previous requirements in US GAAP on the consideration that a vendor gives to a customer used the term 'identifiable benefit', which was described as a good or service that is 'sufficiently separable from the recipient's purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products or services in order to receive that benefit'. The boards concluded that the principle in IFRS 15 for assessing whether a good or service is distinct is similar to the previous requirements in US GAAP.

BC257 The amount of consideration received from a customer for goods or services, and the amount of any consideration paid to that customer for goods or services, could be linked even if they are separate events. For instance, a customer may pay more for goods or services from an entity than it would otherwise have paid if it was not receiving a payment from the entity. Consequently, the boards decided that to depict revenue faithfully in those cases, any amount accounted for as a payment to the customer for goods or services received should be limited to the fair value of those goods or services, with any amount in excess of the fair value being recognised as a reduction of the transaction price.

BC258 If the payment of consideration is accounted for as a reduction of the transaction price, an entity would recognise less revenue when it satisfies the related performance obligation(s). However, in some cases, an entity promises to pay consideration to a customer only after it has satisfied its performance obligations and, therefore, after it has recognised revenue. When this is the case, a reduction in revenue should be recognised immediately. Accordingly, the boards clarified that the reduction of revenue is recognised at the later of when the entity transfers the goods or services to the customer and when the entity promises to pay the consideration. By using the phrase 'promises to pay', the boards clarified that an entity should reflect in the transaction price payments

to customers that are conditional on future events (for example, a promise to pay a customer that is conditional on the customer making a specified number of purchases would be reflected in the transaction price when the entity makes the promise).

Customer credit risk

- BC259 The 2010 Exposure Draft proposed that an entity would recognise revenue at the amount that the entity expects to *receive* from the customer. In other words, the customer's credit risk would be reflected in the measurement of the transaction price allocated to the performance obligations in the contract.
- BC260 Many respondents to the 2010 Exposure Draft commented specifically about the proposed requirements for customer credit risk. Although some respondents agreed with the proposal that the transaction price should reflect the customer's credit risk, nearly all respondents (including preparers, users of financial statements and securities regulators) expressed concerns about applying that concept in practice. In particular, many users of financial statements commented that they would prefer revenue to be measured at the 'gross' amount so that revenue growth and receivables management (or bad debts) could be analysed separately. Those users of financial statements indicated that they were interested in assessing the performance of an entity's sales function and receivables collection function separately because those functions are often managed separately. However, that information would not be available if an entity's assessment of sales and collectability were reflected only on a 'net' basis in the revenue line.
- BC261 After considering that feedback, the boards decided not to adopt that proposal. Instead, in the 2011 Exposure Draft, the boards proposed that revenue should be recognised at the amount to which the entity expects to be entitled, which would not reflect any adjustments for amounts that the entity might not be able to collect from the customer. However, to provide transparency to all users of financial statements for the portion of the entity's gross revenue that is expected to be uncollectable, the boards proposed to link the presentation of the revenue line and the impairment loss line. Consequently, the 2011 Exposure Draft proposed that initial and subsequent impairment losses (and reversals) on transactions that did not include a significant financing component should be presented as a separate line item adjacent to the revenue line item.
- BC262 In redeliberating the 2011 Exposure Draft, the boards considered the following challenges arising from the proposed linked presentation of revenue and impairment losses:
- (a) different interpretations might have emerged about whether the reported revenue amount of the entity is the gross revenue before the impairment losses that are presented adjacent to revenue or the net revenue after those impairment losses.
 - (b) the impairment losses that would have been presented as a separate line item adjacent to the revenue line item might have related to uncollectable consideration that had been recognised as revenue in previous reporting periods. Consequently, there would not necessarily be a connection between the revenue recognised in a particular reporting period and the impairment losses that would have been presented adjacent to the revenue line item in that period.
 - (c) the impairment losses on short-term trade receivables (ie receivables arising from contracts with customers that do not have separately identified financing components) would have been presented differently from all other financial assets that are subject to impairment. This is because the impairment losses for short-term trade receivables would have been presented adjacent to revenue, whereas for all other financial assets, impairment losses would have been presented together with other expense items in the statement of comprehensive income. For the reasons described in paragraphs BC244–BC247, those other financial assets would have included receivables arising from contracts with customers that include a financing component that is significant to the contract.
- BC263 The boards considered addressing some of those challenges by requiring that initial impairment losses be presented adjacent to the revenue line item and subsequent impairment losses be presented as a separate expense. The boards observed that this approach would have provided a clearer link between revenue and the impairment losses related to the revenue recognised in that

period. However, many respondents noted that it would have been challenging to distinguish between initial and subsequent impairment losses without incurring significant costs to obtain the information.

- BC264 Consequently, the boards decided to modify the presentation requirements for impairment losses and to require disclosure of impairment losses on short-term trade receivables arising from a contract with a customer separate from other impairment losses (if not otherwise presented and subject to the usual materiality considerations). The boards decided that this approach is the most appropriate because it addresses the challenges identified in the 2011 Exposure Draft and still provides users of financial statements with the information that they had said would be most useful, which is gross revenue to provide revenue trend information and the impairment loss to provide information on receivables management (or bad debts). Furthermore, the boards noted that this would provide greater consistency with the accounting for impairment losses on contracts with customers that include a significant financing component.
- BC265 However, the boards were concerned that for some transactions in which there is significant credit risk at contract inception, an entity might recognise revenue for the transfer of goods or services and, at the same time, recognise a significant bad debt expense. The boards decided that in those cases, 'grossing up' revenue and recognising a significant impairment loss would not faithfully represent the transaction and would not provide useful information. Consequently, the boards included the criterion in paragraph 9(e) of IFRS 15 (see paragraphs BC42–BC46).

Allocating the transaction price to performance obligations (paragraphs 73–86)

- BC266 The boards decided that an entity should generally allocate the transaction price to all performance obligations in proportion to the stand-alone selling prices of the goods or services underlying each of those performance obligations at contract inception (ie on a relative stand-alone selling price basis). They decided that in most cases an allocation based on stand-alone selling prices faithfully depicts the different margins that may apply to promised goods or services.
- BC267 Most respondents agreed with the requirement to allocate the transaction price on a relative stand-alone selling price basis. Some of those respondents observed that the requirements were broadly consistent with previous changes to US GAAP for multiple-element arrangements. However, respondents expressed concerns about the following topics:
- (a) estimating the stand-alone selling price; and
 - (b) allocating discounts and contingent consideration.

Estimating stand-alone selling prices (paragraphs 76–80)

- BC268 IFRS 15 specifies that if an entity does not have an observable price from selling a good or service separately, the entity should instead estimate the stand-alone selling price. Paragraph 79 of IFRS 15 includes examples of suitable estimation methods for estimating the stand-alone selling price. However, the boards decided not to preclude or prescribe any particular method for estimating a stand-alone selling price so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer. The boards clarified that the method used by the entity to estimate a stand-alone selling price should maximise the use of observable inputs and should be applied consistently to estimate the stand-alone selling price of other goods or services with similar characteristics.
- BC269 The boards observed that many entities may already have robust processes for determining stand-alone selling prices on the basis of reasonably available data points and the effects of market considerations and entity-specific factors. However, other entities may need to develop processes for estimating selling prices of goods or services that are typically not sold separately. The boards decided that when developing those processes, an entity should consider all reasonably available information on the basis of the specific facts and circumstances. That information might include the following:

- (a) reasonably available data points (for example, a stand-alone selling price of the good or service, the costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing and the pricing of other goods or services in the same contract);
- (b) market conditions (for example, supply and demand for the good or service in the market, competition, restrictions and trends);
- (c) entity-specific factors (for example, business pricing strategies and practices); and
- (d) information about the customer or class of customer (for example, type of customer, geographical region and distribution channel).

Residual approach

- BC270 In response to questions from respondents, the boards decided to specify that a residual approach might be a suitable technique for estimating the stand-alone selling price of a good or service. Using a residual approach, an entity would estimate a stand-alone selling price of a good or service on the basis of the difference between the total transaction price and the (observable) stand-alone selling prices of other goods or services in the contract.
- BC271 The boards also decided to specify how and when an entity can use the residual approach as an estimation method in paragraph 79(c) of IFRS 15. Specifically, in situations in which one or more promised goods or services have a stand-alone selling price that is highly variable or uncertain. In specifying those circumstances, the boards were particularly mindful of the challenges in determining stand-alone selling prices in contracts for intellectual property and other intangible products. In those arrangements, the pricing can be highly variable because there is little or no incremental cost to the entity in providing those goods or services to a customer. In those circumstances, the most reliable way of determining the stand-alone selling price in the contract will often be to use a residual approach. For the same reason, the boards noted that the residual approach might be appropriate in situations in which an entity has not yet established the selling price for a good or service that previously has not been sold on a stand-alone basis.
- BC272 Most respondents agreed with the boards' proposals on the residual approach. However, some respondents, particularly those in the software industry, asked the boards to clarify whether they could use a residual approach if there is more than one good or service in the contract with highly variable or uncertain stand-alone selling prices. Those respondents observed that this may occur in contracts that include three or more performance obligations, in which at least one of the performance obligations has an observable stand-alone selling price. The boards decided that even if a contract includes more than one good or service with a highly variable or uncertain stand-alone selling price, an entity should not be prevented from applying the residual approach because it may still be a reliable method for determining the stand-alone selling price. However, the boards observed that using the residual approach when there are two or more goods or services with highly variable or uncertain stand-alone selling prices may require an entity to use a combination of techniques to estimate the stand-alone selling prices as follows:
- (a) apply the residual approach to estimate the aggregate of the stand-alone selling prices for all the promised goods or services with highly variable or uncertain stand-alone selling prices; and
 - (b) then use another technique to estimate the stand-alone selling prices of each of those promised goods or services with highly variable or uncertain stand-alone selling prices.
- BC273 In determining whether the estimate is reasonable, the boards observed that it was important to understand that the residual approach for estimating the stand-alone selling price of a promised good or service is different from the residual method permitted under previous revenue Standards. This is because in IFRS 15 the residual approach is used to determine the stand-alone selling price of a distinct good or service. By definition, the outcome of this approach cannot realistically result in a stand-alone selling price of zero if the good or service is in fact distinct because to be distinct that good or service must have value on a stand-alone basis. In contrast, the residual method in previous revenue Standards could have resulted in an outcome of zero because the residual method was an allocation method. Thus, under previous revenue recognition

requirements, zero could be the only amount of consideration that remained to be allocated to a performance obligation. Consequently, the boards noted that if the residual approach in paragraph 79(c) of IFRS 15 results in no, or very little, consideration being allocated to a good or service or a bundle of goods or services, the entity should consider whether that estimate is appropriate in those circumstances.

Specifying a hierarchy of evidence

- BC274 The boards decided not to specify a hierarchy of evidence to determine the stand-alone selling price of a good or service. Instead, they decided to emphasise that an entity should maximise the use of observable inputs when developing estimates of stand-alone selling prices.
- BC275 Most respondents agreed with the boards' decision not to prescribe a hierarchy of evidence for estimating a stand-alone selling price. However, some respondents recommended that the boards should specify a hierarchy of evidence, because specifying a hierarchy of evidence for determining stand-alone selling prices (and requiring disclosures using that hierarchy) would enhance the quality and reliability of an entity's reported revenues. The hierarchy suggested by those respondents was similar to that in previous revenue Standards:
- (a) if vendor-specific objective evidence of a selling price is available, an entity would use this price to determine the selling price of a promised good or service;
 - (b) if vendor-specific objective evidence is not available, an entity would determine the selling price using third-party evidence, if available; and
 - (c) if third-party evidence is not available, an entity would use its best estimate of the selling price.
- BC276 The boards observed that IFRS 15 requires an entity to use observable prices when a good or service is sold separately by the entity (which is similar to a vendor-specific objective evidence notion). It is only when a good or service is not sold separately that an entity is required to estimate the stand-alone selling price. In that estimation process, an entity is still required to maximise the use of observable inputs. The boards noted that in the hierarchy in paragraph BC275 there is little distinction between third-party evidence and a best estimate of a selling price. For instance, third-party evidence of a selling price might require adjustments to reflect differences in either (a) the good or service (because the third-party price could be for a similar, rather than an identical, good or service) or (b) pricing strategies between the third party and the entity. Therefore, the boards affirmed their decision not to specify a hierarchy in IFRS 15. Instead, the boards decided that it was important to emphasise that an entity should maximise the use of observable inputs when developing estimates of stand-alone selling prices.

Allocating discounts and variable consideration (paragraphs 81–86)

- BC277 A consequence of allocating the transaction price on a relative stand-alone selling price basis is that any discount in the contract is allocated proportionately to each of the performance obligations in the contract. Some respondents noted that this would not always faithfully depict the amount of consideration to which an entity is entitled for satisfying a particular performance obligation. For example, those respondents noted that the allocation of the discount could result in a loss on one part of the contract although the contract as a whole may be profitable (for example, the contract contains both a high-margin item and a low-margin item). They suggested that the boards should permit an entity to allocate the discount in a contract using one of the following alternatives:
- (a) a management approach, in which an entity would assess which promised good or service is priced at a discount to its stand-alone selling price.
 - (b) a residual approach, in which any discount in the contract would be allocated entirely to the satisfied performance obligations.
 - (c) a profit margin approach, in which an entity would allocate the discount in a contract in proportion to the individual profit margin on each performance obligation. The individual

profit margin for each performance obligation is the difference between the stand-alone selling price and the direct costs of the good or service underlying each performance obligation.

- BC278 Another consequence of allocating the transaction price on a relative stand-alone selling price basis is that any amount of consideration that is variable will be allocated to each of the performance obligations in the contract. Some respondents noted that this allocation will not always faithfully depict the amount of consideration to which an entity is entitled upon satisfying a particular performance obligation, if the variable consideration does not relate to all of the performance obligations in the contract. Many suggested that any adjustment in the transaction price as a result of variable amounts should be allocated only to the performance obligation(s) to which the variable amounts relate.
- BC279 The boards noted that the objective of the revenue recognition model is for an entity to recognise revenue in the amount of consideration to which it expects to be entitled from the customer in exchange for transferring goods or services. The relative stand-alone selling price basis allocation is simply a method to achieve that objective rather than being the allocation principle.
- BC280 However, the boards also noted that allocating the transaction price on a relative stand-alone selling price basis brings rigour and discipline to the process of allocating the transaction price and, therefore, enhances comparability both within an entity and across entities. Consequently, the boards decided that it should be the default method for allocating the transaction price. However, they agreed with respondents that it might not always result in a faithful depiction of the amount of consideration to which the entity expects to be entitled from the customer. Accordingly, in paragraphs 81–86 of IFRS 15, the boards specified the circumstances in which other methods should be used.

Allocating discounts (paragraphs 81–83)

- BC281 IFRS 15 requires an entity to allocate a discount entirely to one or more, but not all, performance obligations in the contract if the entity has observable selling prices for each performance obligation in the contract and those observable stand-alone selling prices provide evidence that the entire discount in the contract is specifically attributable to one or more of those performance obligations. Those requirements are largely based on the ‘contract segmentation’ principle that was included in the 2010 Exposure Draft, which only allowed a discount to be allocated entirely to one or more performance obligations on the basis of goods or services that are priced independently.
- BC282 Some respondents questioned whether the requirements in paragraph 82 of IFRS 15 for allocating a discount are too restrictive and, therefore, might yield outcomes that are inconsistent with the economics of some transactions. However, the boards noted that the requirements are included to maintain the rigour and discipline of a stand-alone selling price allocation and, thus, appropriately restrict the situations in which a discount should not be allocated pro rata to all performance obligations in the contract.
- BC283 The boards also noted that paragraph 82 of IFRS 15 would typically apply to contracts for which there are at least three performance obligations. This is because an entity could demonstrate that a discount relates to two or more performance obligations when it has observable information supporting the stand-alone selling price of a group of those promised goods or services when they are sold together. The boards noted that it may be possible for an entity to have sufficient evidence to be able to allocate a discount to only one performance obligation in accordance with the criteria in paragraph 82, but the boards expected that this could only occur in rare cases.

Allocating variable consideration (paragraphs 84–86)

- BC284 The boards agreed with respondents that it would not always be appropriate for an entity to allocate the variable consideration in a transaction price to all of the performance obligations in a contract. For example, an entity may contract to provide two products at different times with a bonus that is contingent on the timely delivery of only the second product. In that example, it might be inappropriate to attribute variable consideration included in the transaction price to both products. Similarly, an entity may contract to provide two products at different times with a fixed amount for the first product that represents that product’s stand-alone selling price, and a variable

amount that is contingent on the delivery of the second product. That variable amount might be excluded from the estimate of the transaction price (ie because of the requirements for constraining estimates of the transaction price). In that case, it might be inappropriate to attribute the fixed consideration included in the transaction price to both products. Consequently, the boards specified the criteria in paragraphs 84–86 of IFRS 15 to identify the circumstances in which an entity should allocate the variable consideration entirely to a performance obligation or to a distinct good or service (that forms part of a single performance obligation) rather than to the contract as a whole. The boards decided that those criteria are necessary to ensure an appropriate allocation of the transaction price when there is variable consideration in the transaction price.

- BC285 The boards clarified in paragraph 84(b) of IFRS 15 that variable consideration can be allocated to distinct goods or services even if those goods or services form a single performance obligation. The boards made this clarification to ensure that an entity can, in some cases, attribute the reassessment of variable consideration to only the satisfied portion of a performance obligation when that performance obligation meets the criterion in paragraph 22(b) of IFRS 15. Consider the example of a contract to provide hotel management services for one year (ie a single performance obligation in accordance with paragraph 22(b) of IFRS 15) in which the consideration is variable and determined based on two per cent of occupancy rates. The entity provides a daily service of management that is distinct and the uncertainty related to the consideration is also resolved on a daily basis when the occupancy occurs. In those circumstances, the boards did not intend for an entity to allocate the variable consideration determined on a daily basis to the entire performance obligation (ie the promise to provide management services over a one-year period). Instead, the variable consideration should be allocated to the distinct service to which the variable consideration relates, which is the daily management service.

Changes in transaction price

- BC286 The boards also decided to specify that any subsequent changes in the transaction price should be allocated in a manner that is consistent with the allocation methodology at contract inception. This ensures that changes in the estimate of the variable consideration that are included in (or excluded from) the transaction price are allocated to the performance obligation(s) to which the variable consideration relates. Consequently, the boards specified in paragraph 89 of IFRS 15 that an entity should allocate a change in the transaction price entirely to one or more distinct goods or services if the criteria in paragraph 85 of IFRS 15 are met.

Contingent revenue cap and the portfolio approach to allocation

- BC287 Some respondents disagreed with the boards' proposal that the transaction price should be allocated on a relative stand-alone selling price basis. Those respondents (primarily from the telecommunications and cable television industries) disagreed because allocating the transaction price using relative stand-alone selling prices on a contract-by-contract basis could be complex and costly for their industries. This is because entities in those industries:
- (a) have a high volume of contracts with various potential configurations;
 - (b) provide multiple goods and services in those contracts;
 - (c) include a discount in the contracts; and
 - (d) provide the goods or services at different times.
- BC288 Those respondents also disagreed with allocating the transaction price on the basis of relative stand-alone selling prices because it would provide a revenue recognition pattern that they considered would not be useful to users of their financial statements.
- BC289 Those respondents requested that the boards should carry forward previous revenue recognition requirements in US GAAP (previously referred to as 'the contingent revenue cap'). Those requirements were previously used by many telecommunications entities applying US GAAP and IFRS. In the respondents' view, carrying forward those requirements would have simplified the application of the revenue recognition model by limiting the amount of consideration that a telecommunications entity could allocate to a handset that is bundled with network services to the amount that is not contingent on the delivery of network services in the future. Consequently,

revenue would have been recognised at the amount that the customer paid for the handset at contract inception when the handset was transferred to the customer. The remaining contractual payments would have been recognised subsequently as revenue as the entity provided network services to the customer. Many users of financial statements of entities in the telecommunications industry agreed that this revenue recognition pattern would have been useful because it closely relates to the timing of cash received.

BC290 Respondents from the telecommunications industry commented that without a contingent revenue cap, not only will the application of the revenue recognition model be complex, but revenue will also be recognised for delivering a handset in an amount that exceeds the amount of consideration paid for the handset. In their view, this is inappropriate because it will not be useful to users of their financial statements and, in a separate objection, because they will be entitled to collect the excess only when they provide the network services. Consequently, they reasoned that the contract asset that will result from recognising revenue for delivery of the handset will not meet the definition of an asset. In addition, they suggested that without a contingent revenue cap, the model will be complex and costly to apply because of the high volume of contracts that they will have to manage and the various potential configurations of handsets and network service plans.

BC291 However, the boards decided not to carry forward the contingent revenue cap for the following reasons:

- (a) limiting the amount of consideration that can be allocated to a satisfied performance obligation is tantamount to cash-basis accounting and does not meet the core principle of IFRS 15. This is because revenue recognised would not depict the amount of consideration to which an entity expects to be entitled for the delivered good or service. Consequently, the contingent revenue cap could result in economically similar contracts being accounted for differently.
- (b) the contingent revenue cap can result in the recognition of losses if the contract is profitable. That would occur if the amount allocated to a satisfied performance obligation is limited to an amount (potentially to zero) that is less than the expenses recognised for the costs of providing the good or service (unless those costs are deferred). However, costs relating to a good or service already transferred to a customer would not give rise to an asset.
- (c) recognising a contract asset in the situation described in paragraph BC290 is appropriate because the entity has a valuable contractual right as a result of satisfying a performance obligation and that right meets the definition of an asset. That right exists even if the entity does not have the unconditional right to collect consideration from the customer. This is because if the entity were to transfer the remaining rights and performance obligations in the contract to a third party after it had delivered a handset, it would expect to be compensated for that past performance.
- (d) applying the contingent cap more broadly than it was applied in previous revenue Standards could have had far-reaching consequences. For example, in many service contracts (including construction contracts), it is appropriate to recognise revenue when services are provided even though the amount of consideration is contingent on the entity's future performance. Otherwise, the entity would not recognise any revenue until reaching a contract milestone or potentially until completion of the contract (which would not depict the transfer of goods or services to the customer).
- (e) although the consequences for construction and other service contracts could have been reduced by limiting the amount allocated to satisfied performance obligations (rather than limiting the amount allocated to a satisfied portion of a single performance obligation), the boards decided that this would have created an arbitrary distinction and would have put additional pressure on the criteria for identifying performance obligations.
- (f) for many contracts that were previously accounted for under the contingent revenue cap, the amount of consideration allocated to delivered items was not contingent because, even if the customer cancelled the contract, the customer would have been obliged to pay for the delivered item(s). For example, in some contracts for the sale of a handset and network services, either the contract was not cancellable or, if it was, the customer

was obliged to pay a termination fee that corresponded with the value of the handset that was delivered upfront (even if the entity might choose not to enforce payment of that fee).

- BC292 In addition, the boards decided not to introduce an exception to the revenue recognition model for telecommunications and similar contracts because they do not view those contracts as being different from other contracts in which an entity transfers a bundle of goods or services. Furthermore, the boards decided that IFRS 15 provides a more consistent basis for recognising revenue and produces results in accounting that more closely match the underlying economics of transactions.
- BC293 The boards also observed that entities in the telecommunications industry may be able to simplify the application of the model by using portfolio techniques (as envisioned by the practical expedient specified in paragraph 4 of IFRS 15) to allocate the transaction price for a group of similar contracts (see paragraphs BC69–BC70). The boards considered whether they should provide more specific guidance as to when an entity could use a portfolio approach for allocating the transaction price. However, the boards decided not to do so because they were concerned that any further guidance (for example, by including criteria that an entity would need to meet to apply a portfolio approach) might make the practical expedient less useful across entities or jurisdictions.

Onerous performance obligations

- BC294 In the 2010 and the 2011 Exposure Drafts, the boards proposed including requirements for identifying and measuring onerous performance obligations in contracts with customers (ie an ‘onerous test’). In those proposals, the boards concluded that an onerous test was needed because the initial measurements of performance obligations are not routinely updated. In addition, the boards noted that including an onerous test would achieve greater convergence of IFRS and US GAAP.
- BC295 However, many respondents to the 2010 and the 2011 Exposure Drafts disagreed with the onerous test and highlighted a number of practical application difficulties. Furthermore, many explained that strict application of the onerous test would have resulted in recognition of liabilities in cases in which the outcome of fulfilling a single performance obligation was onerous but the outcome of fulfilling the entire contract would be profitable. A number of respondents suggested removing the onerous test from the revenue proposals because, in addition to being complex and difficult to apply, the requirements for recognition of onerous losses are already sufficiently addressed in other Standards. Those respondents commented that:
- (a) for IFRS, the onerous test in IAS 37 and the requirements in IAS 2 *Inventories* already provide sufficient guidance for determining when to recognise losses arising from contracts with customers.
 - (b) for US GAAP, existing requirements for recognition of losses from contracts are adequate and if a change to those requirements is necessary, that change could instead be handled in a separate project that addresses liabilities in Topic 450.
- BC296 The boards agreed that existing requirements in both IFRS and US GAAP could adequately identify onerous contracts. Furthermore, the boards noted that although their existing requirements for onerous contracts are not identical, they are not aware of any pressing practice issues resulting from the application of those existing requirements. Consequently, the boards decided that IFRS 15 should not include an onerous test. Instead, entities applying IFRS or US GAAP will use their respective existing requirements for the identification and measurement of onerous contracts.

Contract costs (paragraphs 91–104)

Incremental costs of obtaining a contract (paragraphs 91–94)

- BC297 The boards decided that an entity should recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The boards defined the incremental costs of obtaining a contract as the costs that an entity incurs in its efforts to obtain a contract that would not have been incurred if the contract had not been obtained. The boards acknowledged that, in some cases, an entity’s efforts to recognise an asset from incremental

acquisition costs might exceed the financial reporting benefits. Consequently, as a practical expedient, the boards decided to allow an entity to recognise those costs as expenses when incurred for contracts in which the amortisation period for the asset that the entity otherwise would have recognised is one year or less.

- BC298 The boards considered requiring an entity to recognise all of the costs of obtaining a contract as expenses when those costs are incurred. The boards observed that, conceptually, an entity may obtain a contract asset as a result of its efforts to obtain a contract (because the measure of the remaining rights might exceed the measure of the remaining obligations). However, because the principle in IFRS 15 requires an entity to recognise a contract asset and revenue only as a result of satisfying a performance obligation in the contract, the boards observed that on the basis of that reasoning, the contract asset would be measured at zero at contract inception and any costs of obtaining a contract would therefore be recognised as expenses when incurred.
- BC299 Many respondents disagreed with recognising all costs to obtain a contract as expenses when incurred because those costs meet the definition of an asset in some cases. In addition, they noted the following:
- (a) other Standards require some of the costs of obtaining a contract to be included in the carrying amount of an asset on initial recognition; and
 - (b) the recognition of the costs of obtaining a contract as expenses would be inconsistent with the tentative decisions in the boards' projects on leases and insurance contracts.
- BC300 During the redeliberations, the boards decided that, in some cases, it might be misleading for an entity to recognise all the costs of obtaining a contract as expenses, when incurred. For example, the boards observed that recognising the full amount of a sales commission as an expense at inception of a long-term service contract (when that sales commission is reflected in the pricing of that contract and is expected to be recovered) would fail to acknowledge the existence of an asset.
- BC301 Consequently, the boards decided that an entity would recognise an asset from the costs of obtaining a contract and would present the asset separately from the contract asset or the contract liability. To limit the acquisition costs to those that can be clearly identified as relating specifically to a contract, the boards decided that only the incremental costs of obtaining a contract should be included in the measurement of the asset, if the entity expects to recover those costs. The boards decided that determining whether other costs relate to a contract is too subjective.
- BC302 The boards noted that it might be difficult for some entities to determine whether a commission payment is incremental to obtaining a new contract (for example, payment of a commission might depend on the entity successfully acquiring several contracts). The boards considered whether to allow an accounting policy election for contract costs, under which an entity would have been able to choose to recognise an asset from the acquisition costs or recognise those costs as an expense (with disclosure of the accounting policy election). The boards noted that this would have been consistent with previous revenue recognition requirements in US GAAP for public entities. However, the boards noted that introducing accounting policy elections into IFRS 15 would have reduced comparability and therefore would not have met one of the key objectives of the Revenue Recognition project to improve comparability in accounting among entities and industries. Consequently, the boards decided not to allow entities an accounting policy election with respect to contract acquisition costs.
- BC303 The FASB noted that depending on the specific facts and circumstances of the arrangement between an asset manager and the other parties in the relationship, the application of the requirements for incremental costs of obtaining a contract might have resulted in different accounting for sales commissions paid to third-party brokers (ie in some cases the commission would have been recognised as an asset while in others it would have been recognised as an expense). The FASB observed that it had not intended the application of the cost requirements to result in an outcome for these specific types of sales commissions that would be different from applying existing US GAAP. Consequently, the FASB decided to retain the specific cost requirements for investment companies in paragraph 946-605-25-8 of the Codification which has been moved to Subtopic 946-720 *Financial Services—Investment Companies—Other Expenses*.

Costs to fulfil a contract (paragraphs 95–98)

- BC304 The boards developed requirements for accounting for some costs to fulfil a contract. Those requirements were developed in response to concerns that the proposals in the Discussion Paper focused on how an entity should recognise revenue in a contract without considering how the entity should account for the costs to fulfil a contract. Some respondents, particularly those from the construction industry, said that requirements for profit margin recognition are as important as requirements for revenue recognition. Other respondents, mainly preparers who apply US GAAP, were concerned about the withdrawal of requirements for costs that were developed specifically for their own industries.
- BC305 The cost requirements in IFRS 15 are intended to achieve the following:
- (a) fill the gap arising from the withdrawal of previous revenue Standards—IFRS 15 will result in the withdrawal of some requirements for contract costs, in particular, the previous requirements for accounting for construction contracts.
 - (b) improve current practice—the cost requirements provide clearer requirements for accounting for some costs to fulfil a contract (for example, setup costs for services) and result in an entity no longer having to rely on, or analogue to, requirements that were not developed specifically for contracts with customers. For instance, in accounting for setup costs, an entity applying US GAAP may previously have needed to analogue to the guidance on the deferral of direct loan origination costs in paragraph 310-20-25-2 of the Codification. An entity applying IFRS may have evaluated those costs in accordance with IAS 38 *Intangible Assets*. Specifying clear requirements will also result in greater consistency in practice.
 - (c) promote convergence in accounting for contract costs—more costs will be accounted for similarly under IFRS and US GAAP (although total consistency in accounting for costs to fulfil a contract will not be achieved unless the boards align their respective Standards on inventories; property, plant and equipment; intangible assets and impairment of assets).
- BC306 Most respondents supported the boards' inclusion of requirements that address some of the costs to fulfil a contract. Some respondents recommended that the boards address cost requirements comprehensively in a separate project. However, because cost requirements are included in many Standards (such as the ones described in paragraph BC305(c)), the boards noted that this would require reconsideration of those Standards and, therefore, decided against broadening the scope of the cost requirements.
- BC307 Because the boards decided not to reconsider all cost requirements comprehensively, paragraphs 91–98 of IFRS 15 specify the accounting for contract costs that are not within the scope of other Standards. Consequently, if the other Standards preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognised under IFRS 15 (for example, in IFRS, initial operating losses, such as those incurred while demand for an item builds, will continue to be accounted for in accordance with paragraph 20(b) of IAS 16 and, in US GAAP, pre-production costs under long-term supply arrangements will continue to be accounted for in accordance with paragraphs 340-10-25-5 through 25-8 of the Codification).
- BC308 IFRS 15 clarifies that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. Those requirements ensure that only costs that meet the definition of an asset are recognised as such and that an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. To provide a clear objective for recognising and measuring an asset arising from the costs to fulfil a contract, the boards decided that only costs that relate directly to a contract should be included in the cost of the asset.

Amortisation and impairment (paragraphs 99–104)

- BC309 The boards decided that an entity should amortise the asset recognised from the costs of obtaining and fulfilling a contract in accordance with the pattern of transfer of goods or services to which the asset relates. Respondents broadly agreed; however, some asked the boards to clarify whether

those goods or services could relate to future contracts. Consequently, the boards clarified that in amortising the asset in accordance with the transfer of goods or services to which the asset relates, those goods or services could be provided under a specifically anticipated (ie future) contract. That conclusion is consistent with the notion of amortising an asset over its useful life and with other Standards. However, amortising the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

- BC310 The boards considered testing a recognised asset arising from fulfilment costs for impairment using one of the existing impairment tests in their respective requirements (for example, IAS 2 and IAS 36 *Impairment of Assets* or Topic 330 *Inventory*, Topic 360 *Property, Plant and Equipment* and Subtopic 985-20 *Software—Costs of Software to Be Sold, Leased, or Marketed*). However, the boards decided that an entity should consider only the economic benefits in the contract with the customer and, consequently, the impairment test should be based on comparing the carrying amount of the asset with the remaining amount of promised consideration in exchange for the goods or services to which the asset relates, less the remaining costs of providing those goods or services. The boards decided that for purposes of impairment testing, the entity should consider future cash flows that may be too uncertain to include in the recognition of revenue (see paragraphs BC203–BC223). The boards decided this because their objective for measuring and recognising impairments of contract acquisition and fulfilment costs is different from the measurement objective for revenue. The impairment objective is to determine whether the carrying amount of the contract acquisition and fulfilment costs asset is recoverable. Consequently, the measurement objective is consistent with other impairment methods in IFRS and US GAAP that include an assessment of customer credit risk and expectations of whether amounts of variable consideration will be received.
- BC311 The FASB decided that an entity should not reverse an impairment charge when the reasons for the impairment no longer exist. Conversely, the IASB decided that the impairment charge should be reversed in those circumstances under IFRS. The boards acknowledged that this would result in entities accounting differently for those contract costs using IFRS and US GAAP. However, the boards decided that it is important for the requirements to be consistent with their respective impairment models for other types of assets and those impairment models differ in their accounting for reversals of impairments.

Learning curve

- BC312 A 'learning curve' is the effect of efficiencies realised over time when an entity's costs of performing a task (or producing a unit) decline in relation to how many times the entity performs that task (or produces that unit). The phenomenon of a learning curve can exist independently of a contract with a customer. For example, a typical manufacturer that produces units of inventory would become more efficient in its production process over time. Some respondents asked how to apply the proposals to account for the effects of learning costs in a contract with a customer.
- BC313 The boards noted that IFRS 15 addresses the accounting for the effects of learning costs if both of the following conditions are satisfied:
- (a) an entity has a single performance obligation to deliver a specified number of units; and
 - (b) the performance obligation is satisfied over time.
- BC314 In that situation, an entity recognises revenue by selecting a method of measuring progress that depicts the transfer over time of the good or service to the customer. An entity would probably select a method (for example, cost-to-cost) that results in the entity recognising more revenue and expense for the early units produced relative to the later units. That effect is appropriate because of the greater value of the entity's performance in the early part of the contract because, if an entity were to sell only one unit, it would charge the customer a higher price for that unit than the average unit price the customer pays when the customer purchases more than one unit.
- BC315 In other situations, an entity may promise to deliver a specified number of units in a contract, but that promise does not give rise to a single performance obligation that is satisfied over time. The

boards decided that, in those situations, an entity should apply the requirements of other Standards (for example, IAS 2) for the following reasons:

- (a) if an entity incurs costs to fulfil a contract without also satisfying a performance obligation over time, the entity probably would be creating an asset included within the scope of other Standards (for example, the costs of producing tangible units would accumulate as inventory, and the entity would select an appropriate method of measuring that inventory). In those cases, the boards decided that an entity should not account for the learning curve differently depending on whether or not a contract exists.
- (b) the type of contract described in this paragraph is not the type of contract typically entered into by respondents who asked how the requirements of IFRS 15 would apply to learning curve effects (in most cases, those respondents enter into contracts that would be accounted for as a performance obligation satisfied over time).

BC316 The boards, however, acknowledged the diversity in practice when accounting (in accordance with other Standards) for the costs of products produced under long-term production programmes, but agreed that they could not address these matters as part of the Revenue Recognition project.

Presentation (paragraphs 105–109)

BC317 The boards decided that the remaining rights and performance obligations in a contract should be accounted for and presented on a net basis, as either a contract asset or a contract liability. The boards noted that the rights and obligations in a contract with a customer are interdependent—the right to receive consideration from a customer depends on the entity's performance and, similarly, the entity performs only as long as the customer continues to pay. The boards decided that those interdependencies are best reflected by accounting and presenting on a net basis the remaining rights and obligations in the statement of financial position.

BC318 The boards considered whether the rights and performance obligations in contracts that are subject to the legal remedy of specific performance should be presented on a gross basis, that is, as separate assets and liabilities. The boards observed that in the event of a breach of contract, some contracts require the entity and the customer to perform as specified in the contract. Consequently, unlike most contracts that can be settled net, specific performance contracts generally result in a two-way flow of resources between the customer and the entity. Specific performance contracts are akin to financial contracts that are settled by physical delivery rather than by a net cash payment and for which the units of account are the individual assets and liabilities arising from the contractual rights and obligations.

BC319 However, the boards decided against making an exception for specific performance contracts. This is because the remedy of specific performance is relatively rare and is not available in all jurisdictions. In addition, it is only one of a number of possible remedies that could be awarded by a court if legal action were taken for breach of contract.

BC320 The boards decided that IFRS 15 should not specify whether an entity is required to present its contract assets and contract liabilities as separate line items in the statement of financial position. Instead, an entity should apply the general principles for the presentation of financial statements to determine whether to present contract assets and contract liabilities separately in the statement of financial position. For example, IAS 1 *Presentation of Financial Statements* requires an entity to present separately each class of similar items and items of a dissimilar nature or function unless they are immaterial.

BC321 The boards also observed that some industries have historically used different labels to describe contract assets and contract liabilities or may recognise them in more than one line item either in the financial statements or in the notes. Because that additional detail is often useful to users of those financial statements, the boards decided that an entity could use different descriptions of contract assets, contract liabilities and receivables, and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for users of financial statements to be able to distinguish them.

Relationship between contract assets and receivables

- BC322 When an entity performs first by satisfying a performance obligation before a customer performs by paying the consideration, the entity has a contract asset—a right to consideration from the customer in exchange for goods or services transferred to the customer.
- BC323 In many cases, that contract asset is an unconditional right to consideration—a receivable—because only the passage of time is required before payment of that consideration is due. However, in other cases, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. The boards decided that when an entity satisfies a performance obligation but does not have an unconditional right to consideration, an entity should recognise a contract asset in accordance with IFRS 15. The boards noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. That is because although both would be subject to credit risk, a contract asset is also subject to other risks, for example, performance risk.
- BC324 Once an entity has an unconditional right to consideration, it should present that right as a receivable separately from the contract asset and account for it in accordance with other requirements (for example, IFRS 9 or Topic 310). The boards decided that IFRS 15 need not address the accounting for receivables in addition to revenue recognition. Issues such as the measurement (or impairment) of receivables and disclosures relating to those assets are already addressed in IFRS and US GAAP.
- BC325 In many cases, an unconditional right to consideration arises when the entity satisfies the performance obligation and invoices the customer. For example, a payment for goods or services is typically due and an invoice is issued when the entity has transferred the goods or services to the customer. However, the act of invoicing the customer for payment does not indicate whether the entity has an unconditional right to consideration. For instance, the entity may have an unconditional right to consideration before it invoices (unbilled receivable) if only the passage of time is required before payment of that consideration is due. In other cases, an entity can have an unconditional right to consideration before it has satisfied a performance obligation. For example, an entity may enter into a non-cancellable contract that requires the customer to pay the consideration a month before the entity provides goods or services. In those cases, on the date when payment is due, the entity has an unconditional right to consideration. (However, in those cases, the entity should recognise revenue only after it transfers the goods or services.)
- BC326 The boards observed that in some cases, an entity will have an unconditional right to consideration, even though the entity may be required to refund some or all of that consideration in the future. In those cases, the possible obligation to refund consideration in the future will not affect the entity's present right to be entitled to the gross amount of consideration. In those cases, the boards observed that an entity may recognise a receivable and a refund liability (for example, when a right of return exists).

Disclosure (paragraphs 110–129)

- BC327 Some of the main criticisms from regulators and users of financial statements about prior revenue Standards in IFRS and US GAAP related to the disclosure requirements. Broadly, regulators and users of financial statements found the disclosure requirements to be inadequate and lacking cohesion with the disclosure of other items in the financial statements. This lack of cohesion made it difficult to understand an entity's revenues, as well as the judgements and estimates made by the entity in recognising those revenues. For example, many users of financial statements observed that entities presented revenue in isolation, with the result that users of financial statements could not relate revenue to the entity's financial position. Consequently, one of the boards' goals in undertaking the Revenue Recognition project was to provide users of financial statements with more useful information through improved disclosure requirements. Many respondents broadly supported that goal. However, respondents' views about the proposed disclosure requirements in the 2011 Exposure Draft were polarised—users of financial statements supported the proposed disclosure requirements because those requirements would have been a significant improvement over previous requirements. In contrast, other respondents (primarily preparers) noted that, when viewed as a whole, the proposed disclosure requirements would have resulted in voluminous

disclosures and they questioned whether the proposed disclosures were justifiable on a cost-benefit basis.

- BC328 Because of those polarised views, the boards held workshops with users of financial statements and preparers between September and December 2012 in London (United Kingdom), Tokyo (Japan), and Norwalk and New York City (United States). The objective of those workshops was to discuss issues on disclosure and transition and to identify potential solutions to address both users' needs for useful information and preparers' concerns about the costs of providing that information. As a result of the feedback provided through workshops, other outreach efforts and the comment letters, the boards refined the disclosure requirements proposed in the 2011 Exposure Draft. Those refinements and the reasons for the boards' decisions are explained in paragraphs BC330–BC361.
- BC329 The boards noted that the disclosure requirements in paragraphs 110–129 of IFRS 15 are comprehensive and represent a significant improvement from previous requirements. Some may observe that the overall volume of disclosure has increased compared with previous revenue disclosure requirements. However, the boards observed that, to some extent, concerns about the increased volume were the inevitable consequence of addressing the shortcoming in the previous disclosure requirements. In addition, the boards noted that many entities provide voluntary revenue disclosures outside the financial statements and the boards concluded that the increase in disclosure is necessary to improve previous disclosure practices and the usefulness of financial reporting.

Disclosure objective and materiality (paragraphs 110–112)

- BC330 The boards decided that, consistently with other recent Standards, IFRS 15 should specify an objective for the revenue disclosures. In the boards' view, a clear objective improves the interpretation and implementation of the disclosure requirements. This is because a preparer can assess whether the overall quality and informational value of its revenue disclosures are sufficient to meet the stated objectives. The boards also observed that specifying an overall disclosure objective avoids the need for detailed and prescriptive disclosure requirements to accommodate the many and varied types of contracts with customers that are within the scope of IFRS 15.
- BC331 The boards also decided to include disclosure requirements to help an entity meet the disclosure objective. However, those disclosures should not be viewed as a checklist of minimum disclosures, because some disclosures may be relevant for some entities or industries but may be irrelevant for others. The boards also observed that it is important for an entity to consider the disclosures together with the disclosure objective and materiality. Consequently, paragraph 111 of IFRS 15 clarifies that an entity need not disclose information that is immaterial.

Contracts with customers

- BC332 To provide context for the disclosures, the boards decided to require an entity to disclose the amount of revenue recognised from contracts with customers. The FASB noted that in the absence of a general financial statement presentation standard, it would require an entity to present or disclose the amount of revenue recognised from contracts with customers. However, the IASB noted that the general principles of IAS 1 would apply and, therefore, an entity would need to disclose the amount of revenue recognised from contracts with customers in the notes to the financial statements only if it was not otherwise presented.
- BC333 In addition to the amount of revenue recognised, the boards also decided to require an entity to disclose impairment losses from contracts with customers (if not presented in the statement of comprehensive income). The boards made this decision as a consequence of their previous decisions not to reflect customer credit risk in the measurement of the transaction price and, therefore, the amount of revenue recognised for transactions that do not include a significant financing component (see paragraphs BC259–BC265). This is reflected in the core principle of IFRS 15 that specifies that an entity recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled.
- BC334 In the light of those decisions, the boards decided that separately disclosing (or presenting) the impairment losses on contracts with customers provides the most relevant information to users of financial statements.

Disaggregation of revenue (paragraphs 114–115)

- BC335 Revenue recognised in the statement of comprehensive income is a composite amount arising from many contracts with customers. This is because revenue can arise from the transfer of different goods or services and from contracts that involve different types of customers or markets. Users of financial statements explained that understanding those differences was critical to their analyses. Consequently, the boards decided to require an entity to provide disaggregated revenue information to help users of financial statements understand the composition of the revenue from contracts with customers recognised in the current period.
- BC336 In developing the requirements for disclosing disaggregated revenue, the boards observed that some previous revenue recognition requirements required revenue to be disaggregated into its significant categories, including revenue arising from goods or services. However, because the most useful disaggregation of revenue depends on various entity-specific or industry-specific factors, the boards decided that IFRS 15 should not prescribe any specific factor to be used as the basis for disaggregating revenue from contracts with customers. Instead, the boards decided to specify in paragraph 114 of IFRS 15 an objective for providing disaggregated information. The boards noted that specifying an objective will result in the most useful information for users of financial statements, because it enables an entity to disaggregate revenue into categories that are meaningful for its business. In addition, specifying an objective should result in disaggregation that is neither too aggregated nor too detailed.
- BC337 The boards also decided to provide application guidance because of requests for additional guidance about how to implement the objective and, in particular, how to determine the appropriate categories that an entity may use to disaggregate revenue from contracts with customers. The application guidance explains that the most appropriate categories depend on facts and circumstances; however, an entity should consider how revenue is disaggregated in other communications or for the purposes of evaluating financial performance. This is because entities often already disaggregate revenue in those communications and the categories used may be those that are most useful for users of financial statements and that meet the objective in paragraph 114 of IFRS 15. The application guidance also includes a list of examples of categories (for example, geographical region or product type) by which an entity might disaggregate its revenue. The boards noted that the list of categories was compiled as examples that could be applied to many different entities, industries and contracts. As a result, the list should not be viewed either as a checklist or as an exhaustive list. However, the boards observed that an entity may need to disaggregate by more than one category to meet the objective.
- BC338 The boards also decided to require that an entity explain the relationship between the disaggregated revenue information required by paragraph 114 of IFRS 15 and the segment information required by IFRS 8 *Operating Segments* and Topic 280 *Segment Reporting*. The boards decided this because users of financial statements explained that it is critical to their analyses to understand not only the composition of revenue, but also how that revenue relates to other information provided in segment disclosures such as costs of goods sold, expenses and assets used.
- BC339 In developing the requirements, the boards also considered whether the current segment reporting requirements in IFRS 8 and Topic 280 provided adequate information for users of financial statements in understanding the composition of revenue. Those requirements require an entity to disaggregate and disclose revenue for each operating segment (reconciled to total revenue). In addition, those requirements also require an entity to disaggregate total revenue by products or services (or by groups of similar products or services) and geographical areas—if the entity's operating segments are not based on those factors.
- BC340 However, despite some similarity to segment reporting, the boards decided to require disaggregated revenue information for revenue from contracts with customers in IFRS 15 because some entities are exempt from providing segment disclosures (for example, entities that are not listed on a public stock exchange). Furthermore, the boards observed that segment information might be based on non-GAAP information (ie the revenue that is reported to the chief operating decision maker may be recognised and measured on a basis that is not in accordance with IFRS 15). The boards also observed that the objective of providing segment information in accordance with IFRS 8 or Topic 280 is different from the objective for the disaggregation disclosure in IFRS 15 and, therefore, segment revenue disclosures may not always provide users of financial statements with enough information to help them understand the composition of revenue recognised in the

period. Nonetheless, the boards clarified in paragraph 112 of IFRS 15 that an entity does not need to provide disaggregated revenue disclosures if the information about revenue provided in accordance with IFRS 8 or Topic 280 meets the requirements specified in paragraph 114 of IFRS 15 and those revenue disclosures are based on the recognition and measurement requirements in IFRS 15.

Contract balances (paragraphs 116–118)

- BC341 Users of financial statements explained that they need to understand the relationship between the revenue recognised in a reporting period and the changes in the balances of the entity's contract assets and contract liabilities (ie contract balances) to assess the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Those users of financial statements noted that even though many entities currently recognise working capital balances such as unbilled receivables and deferred revenue, previous revenue recognition requirements did not require adequate disclosure about the relationship between those balances and the amount of revenue recognised. Consequently, the 2010 and the 2011 Exposure Drafts proposed that an entity disclose a reconciliation of the contract asset and the contract liability balances in a tabular format.
- BC342 However, many preparers strongly opposed any requirements to reconcile the contract asset and the contract liability balances in a tabular format. Those preparers noted that it would be costly to compile and present the information because it was not tracked. Preparers also questioned the usefulness of this reconciliation to users of financial statements, because the information was not used by management. In contrast, users of financial statements reiterated that some of the information in the reconciliation would be useful, including the information about contract liabilities, which would provide greater transparency about future revenues, which is critical to their analyses. However, users of financial statements also acknowledged that the rigid format of the proposed reconciliation had limitations that would have reduced its usefulness. This is because, for example, changes in contract assets and contract liabilities would have been disclosed on an aggregate basis (ie changes in contract assets would have been offset by changes in contract liabilities) and, therefore, the extent of the changes in contract balances (and the reasons for those changes) would have been obscured.
- BC343 In the discussion at the disclosure and transition workshops in 2012 (see paragraph BC328), preparers agreed that they could provide further information about contract balances that would be useful to users of financial statements. However, to limit the costs of providing that information, those preparers explained that they need greater flexibility in the format of this disclosure. Users of financial statements emphasised that it was critical to them to have information on the movements in the contract balances presented separately because it would help them understand information about the following:
- (a) the amount of the opening balance of the contract liability balance that will be recognised as revenue during the period; and
 - (b) the amount of the opening balance of the contract asset that will be transferred to accounts receivable or collected in cash during the period.
- BC344 Before addressing concerns about format, the boards considered whether they could address the cost concerns of preparers by limiting the scope of the reconciliation requirements to only contract balances for specific types of contracts (for example, long-term contracts). They did this because many users of financial statements observed that information about contract balances would be particularly important for entities that enter into long-term contracts with customers or that carry significant contract liability balances for other reasons (for example, prepaid service contracts). However, the boards rejected this alternative for the following reasons:
- (a) it would have been difficult to clearly identify the types of contracts or industries for which a reconciliation would (or would not) provide useful information.
 - (b) limiting the scope of the reconciliation would have added complexity. This is because limiting the scope could have resulted in excluding some of an entity's contract assets and contract liabilities from the reconciliation and, therefore, additional information would

have been required to relate the reconciled amounts of contract assets or contract liabilities to those recognised in the statement of financial position.

- (c) information on contract balances is useful for other contracts, in addition to long-term contracts, because, for example, there may be a number of contracts or businesses that have significant timing differences between payment and performance.

BC345 In the light of their decision not to limit the scope of the disclosure, the boards considered whether they could instead modify the format of the disclosure to address the concerns of preparers and users of financial statements. The boards observed that neither users of financial statements nor preparers supported the format proposed in the 2010 and the 2011 Exposure Drafts because users of financial statements were concerned that the information about the movements in the contract balances was too aggregated to be useful and because preparers were concerned about the cost of compliance with such a rigid format. The boards acknowledged that a previously rejected alternative format of a gross reconciliation of contract balances (ie to show the remaining contractual rights and performance obligations in separate columns) would have been inappropriate because it would not respond to preparers' concerns about costs. This is because the cost of preparing and auditing the gross reconciliation would have been high, and possibly higher than the 'net' reconciliation proposed in the 2011 Exposure Draft, because an entity would have been required to measure all unperformed contracts which would have required a high level of judgement.

BC346 Consequently, the boards decided that, instead of requiring a tabular reconciliation of the aggregate contract balances, they would require an entity to disclose qualitative and quantitative information about the entity's contract balances (see paragraphs 116–118 of IFRS 15). This approach balances the needs of users of financial statements with preparers' concerns because the qualitative and quantitative disclosures provide users of financial statements with the information they requested (ie information on when contract assets are typically transferred to accounts receivable or collected as cash and when contract liabilities are recognised as revenue). In addition, the boards decided that those disclosures would be more cost-effective than a reconciliation. The boards also observed that this approach would not result in a significant change for many entities that are already disclosing similar information. For example, the boards observed that some long-term construction entities already disclosed information relating to balances similar to contract assets and contract liabilities—often referred to as 'due from customers' or 'unbilled accounts receivable' and 'due to customers' or 'deferred revenue'.

BC347 The boards also decided to require that an entity disclose the amount of revenue recognised in the period that relates to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (for example, as a result of a change in transaction price or estimates related to the constraint on revenue recognised). Disclosing those amounts provides relevant information about the timing of revenue recognition that was not a result of performance in the current period and thus provides useful information about the current period operating results and on predicting future revenues. In addition, the boards noted that this information is not provided elsewhere in the financial statements. Finally, the boards noted that, consistent with general materiality requirements, they did not expect this disclosure to be provided if the amounts are immaterial.

Disclosure of the transaction price allocated to the remaining performance obligations (paragraphs 120–122)

BC348 Many users of financial statements explained that information about the amount and timing of revenue that the entity expects to recognise from its existing contracts would be useful in their analyses of revenue. They also explained that the information would be most useful for long-term contracts, because those contracts typically have the most significant amounts of unrecognised revenue.

BC349 The boards observed that a number of entities often voluntarily disclose information about their long-term contracts, which is commonly referred to as 'backlog' information. (Some entities are also required to produce this information outside the financial statements in regulatory filings.) However, this information is typically presented outside the financial statements and may not be comparable across entities because there is not a common definition of backlog.

BC350 In the light of those factors, the boards decided to specify disclosure requirements to capture information about the amount and timing of revenue that an entity expects to recognise from the remaining performance obligations in the entity's existing contracts. The boards observed that by disclosing that information, an entity would provide users of the entity's financial statements with additional information about the following:

- (a) the amount and expected timing of revenue to be recognised from the remaining performance obligations in existing contracts;
- (b) trends relating to the amount and expected timing of revenue to be recognised from the remaining performance obligations in existing contracts;
- (c) risks associated with expected future revenue (for example, some observe that revenue is more uncertain if an entity does not expect to satisfy a performance obligation until a much later date); and
- (d) the effect of changes in judgements or circumstances on an entity's revenue.

BC351 Many respondents (including most preparers) disagreed with the boards' decision to require such information to be disclosed in the financial statements. Those respondents highlighted different reasons for their disagreement, as follows:

- (a) the disclosure would be difficult and costly to prepare and audit because existing accounting systems are not designed to track and capture the required information, including the information on scheduling the timing of the satisfaction of those remaining performance obligations.
- (b) the information provided by the disclosure could be misinterpreted because, depending on the nature of the entity's business(es), the disclosure may give prominence to only a relatively small subset of the entity's potential future revenues. In addition, the disclosure may include less information than the entity previously included in its backlog disclosure because future and cancellable executory contracts are excluded from the scope of the disclosure.
- (c) the information appeared to be forward-looking in nature and thus should not be presented in the notes to the financial statements.

BC352 In redeliberating the disclosure requirements, taking into consideration the feedback received at the disclosure workshops, the boards observed that the requirement to disclose information about remaining performance obligations should not impose significant incremental costs on an entity because the entity is already required by the revenue recognition requirements to determine and allocate the transaction price to the remaining performance obligations. Nonetheless, the boards decided to address preparers' concerns about costs of preparation as follows:

- (a) providing practical expedients to limit the scope of the disclosure (see paragraph 121 of IFRS 15). The boards decided that including the practical expedient in paragraph 121(a) of IFRS 15 would ease the burden for the preparation of the disclosure and yet would not significantly decrease the usefulness of the information for users of financial statements. This is because users indicated that information for remaining performance obligations is most critical to their analyses when the contracts are long-term. In addition, including the practical expedient in paragraph 121(b) of IFRS 15 would maintain the relief provided to an entity in paragraph B16 of IFRS 15 on measuring progress for those performance obligations (ie performance obligations for which the entity has a right to consideration that corresponds directly with its performance completed to date). The boards provided practical expedients rather than specifically limiting the scope because some preparers commented that it would be easier for them to comply with the requirement from an accounting systems and processes perspective if they could choose to include all of their remaining performance obligations in the disclosure.
- (b) eliminating the prescriptive approach to disclosing when the entity expects to satisfy its remaining performance obligations (see paragraph 120 of IFRS 15). Initially, the boards proposed that an entity should follow a prescriptive approach in determining when the

entity expects to satisfy its remaining performance obligations (ie by requiring a quantitative disclosure of the remaining performance obligations, scheduled into one-year time bands). However, many respondents disagreed with that proposal on the basis that the rigid nature of the prescribed time bands would imply a degree of precision in the timing of revenue recognition that may not exist and, furthermore, would increase the costs of preparation. In response to that feedback, the boards decided to permit an entity to estimate and present such information either on a quantitative basis, with time bands that are most appropriate for the duration of the remaining performance obligations (ie not necessarily one-year time bands) or by using qualitative information (or both).

- BC353 Some users of financial statements also asked for more information to be provided about the relationship between the amounts disclosed as an entity's remaining performance obligations and the entity's contract liabilities. (A contract liability arises if an entity receives consideration from a customer before the entity satisfies its performance obligations to the customer.) This is because the amount of the remaining performance obligations for which cash has been received is useful information. However, the boards noted that contract liabilities are a subset of the amounts disclosed as the transaction price allocated to the remaining performance obligations and paragraph 116(a) of IFRS 15 already requires the contract liability balance to be disclosed. Consequently, the boards decided that no further disclosures should be required.

Performance obligations (paragraph 119)

- BC354 Previous requirements in IFRS and US GAAP require entities to disclose their accounting policies for recognising revenue (see paragraph 10(e) of IAS 1 and the requirements in Topic 235 *Notes to Financial Statements*). However, users of financial statements suggested that in many cases, an entity provides a 'boilerplate' description of the accounting policy adopted without explaining how the accounting policy relates to the contracts that the entity enters into with customers. To address this criticism, paragraph 119 of IFRS 15 requires that an entity disclose information about its performance obligations in contracts with customers. This disclosure complements the accounting policy disclosure requirements in existing Standards by requiring an entity to provide more descriptive information about its performance obligations.

Significant judgements (paragraphs 123–126)

- BC355 IFRS and US GAAP have general requirements for disclosing significant accounting estimates and judgements made by an entity. Because of the importance placed on revenue by users of financial statements, the boards decided to require specific disclosures about the estimates used and the judgements made in determining the amount and timing of revenue recognition.

Assets recognised from the costs to obtain or fulfil a contract with a customer (paragraphs 127–128)

- BC356 The boards decided to require that an entity disclose information about assets that it recognises from the costs to obtain or fulfil a contract, because information about those assets is useful to users. That information will help users of financial statements understand the types of costs that the entity has recognised as assets and how those assets are subsequently amortised or impaired. The boards also decided that this disclosure was necessary to replace some of the previous disclosure requirements that were superseded by IFRS 15.
- BC357 The boards decided not to require that information to be provided as a reconciliation because the cost of providing such a rigid disclosure would outweigh the benefit to users. In addition, most users agreed that the disclosure about the assets recognised from the costs to obtain or fulfil a contract did not need to be provided as a reconciliation to provide relevant information. Consequently, the boards decided to require disclosure of only the most critical information about assets recognised from the costs to obtain or fulfil a contract.

Disclosures required for interim financial reports

- BC358 The boards observed that in the absence of more specific disclosure requirements for interim financial reports, an entity should apply IAS 34 *Interim Financial Reporting* or Topic 270 *Interim Reporting* to determine the information about revenue from contracts with customers that the entity

should disclose in its interim financial reports. Those requirements require, as a general principle, an entity to disclose information about significant changes in its financial position and performance since the end of the last annual reporting period. The boards considered whether to amend IAS 34 and Topic 270 to specify that the entity provide the same quantitative disclosures about revenue in its interim financial reports as those in its annual financial statements.

- BC359 Many preparers and other respondents broadly disagreed with the boards' proposals to make amendments to IAS 34 and Topic 270. They explained that requiring all of the quantitative disclosures in interim financial reports would be too burdensome and difficult to achieve in the short time frames required for interim reporting. In contrast, users of financial statements had mixed views. Some users (including nearly all US-based users) suggested that IAS 34 and Topic 270 should be amended to require the quantitative disclosures because of the importance of revenue and the need to have timely disclosures provided regularly in the interim financial reports. However, other users of financial statements explained that only the information about the disaggregation of revenue was critical to their interim analyses. Those users of financial statements also explained that timeliness in interim reporting was critical and that a requirement to provide other interim disclosures might unnecessarily delay the issuance of interim financial reports.
- BC360 The IASB and the FASB reached different decisions on the amendments to IAS 34 and Topic 270. The IASB decided to amend IAS 34 to only add specific requirements that an entity should disclose disaggregated revenue information in interim financial reports. For all other disclosures related to revenue from contracts with customers, the IASB decided that the general principles of IAS 34 should apply. The IASB decided to add to IAS 34 a requirement to disclose disaggregated revenue information because users of financial statements explained that disaggregation was critical to their analyses and because the information is typically already provided in interim financial statements; therefore, the requirement should not result in an entity incurring significant incremental costs. Furthermore, the general principle of IAS 34 to disclose information about an entity's significant changes in financial position and performance should provide users of financial statements with the other information they need about revenue at an interim reporting period. The IASB decided not to make further changes to IAS 34 without a more comprehensive review of the role of disclosure in interim financial reporting.
- BC361 The FASB decided to amend Topic 270 to require the same quantitative disclosures about revenue in its interim financial reports as those in its annual financial statements (excluding the cost disclosures). The FASB noted that it is helpful to provide entities with certainty about the information that should be provided in interim financial reports. In addition, the FASB observed that an entity would be compiling most of the information required for the disclosures on an interim basis for the purposes of revenue recognition, and therefore disclosing that information might not result in a significant amount of incremental costs. The FASB also observed that this information is useful to users of financial statements in assessing an entity's current and future financial performance.

Application guidance (paragraphs B2–B89)

- BC362 The boards decided to include application guidance to clarify how the principles in IFRS 15 should be applied, including how those principles should be applied to features found in a number of typical contracts with customers. Some of that application guidance has been included based on previous requirements in IFRS or US GAAP that arose as a result of entities requesting clarification in more complex areas of revenue recognition. However, to be consistent with the objective of developing a single revenue recognition model, the boards did not provide requirements that would have applied only to specific industries (see paragraphs BC2–BC3).

Sale with a right of return (paragraphs B20–B27)

- BC363 In some contracts, an entity transfers a good to a customer and also grants the customer the right to return it. The boards decided that, conceptually, a contract with a right of return includes at least two performance obligations—a performance obligation to provide the good to the customer and a performance obligation for the return right service, which is a stand-ready obligation to accept the goods returned by the customer during the return period.

- BC364 In relation to performance obligations to provide customers with goods, the boards decided that, in effect, an entity has made an uncertain number of sales. This is because it is only after the return right expires that the entity will know with certainty how many sales it has made (ie how many sales did not fail). Consequently, the boards decided that an entity should not recognise revenue for the sales that are expected to fail as a result of customers exercising their return rights. Instead, the entity should recognise a liability for its obligation to refund amounts to customers.
- BC365 The boards decided that in determining the amount of revenue to recognise (ie the amount of the refund obligation), an entity should use the principles for recognising and measuring variable consideration. Using those principles, an entity would recognise revenue only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the right of return is subsequently resolved. When the entity determines that it cannot recognise all of the consideration received as revenue for the sale of goods with a right of return, the entity would recognise some of the consideration received as a refund liability.
- BC366 The boards considered whether to account for the return right service as a performance obligation, in addition to any refund liability that is recognised. If an entity does not recognise a performance obligation for the return right service, it should recognise all of the revenue and margin in the contract once the customer obtains control of the good. That outcome might not faithfully depict the entity's performance under the contract. However, the boards noted that accounting for the return right service as a performance obligation, in addition to the refund liability, would typically require the entity to estimate the stand-alone selling price of that service. Because, in many cases, the number of returns is expected to be only a small percentage of the total sales and the return period is often short (such as 30 days), the boards decided that the incremental information provided to users of financial statements by accounting for the return right service as a performance obligation would not have justified the complexities and costs of doing so. Consequently, the boards decided that the return right service should not be accounted for as a performance obligation.
- BC367 A return right gives an entity a contractual right to recover the good from a customer if the customer exercises its option to return the good and obtain a refund. The boards decided that the right to recover the good should be recognised as an asset rather than offset against the refund liability. The boards observed that recognising the asset separately from the refund liability provides greater transparency and ensures that the asset is considered for impairment testing.

Warranties (paragraphs B28–B33)

- BC368 When an entity sells a product (whether that product is a good or service) to a customer, the entity may also provide the customer with a warranty on that product. The warranty might be described as, for example, a manufacturer's warranty, a standard warranty or an extended warranty. The boards decided to provide specific requirements for applying the revenue recognition model to warranties, because many contracts with customers for the sale of products include a warranty and the nature of that warranty may vary across products, entities and jurisdictions.
- BC369 In the Discussion Paper, the boards proposed accounting for all warranties consistently because a unifying feature of all warranties is that an entity promises to stand ready to replace or repair the product in accordance with the terms and conditions of the warranty. The Discussion Paper proposed that a promise to stand ready would provide a customer with a service of warranty coverage, which would have been a performance obligation to which revenue would be attributed. However, most respondents to the Discussion Paper stated that the accounting for warranties should reflect the fact that some product warranties are different from others. Some warranties protect the customer from defects that exist when the product is transferred to the customer and other warranties protect the customer from faults that arise after the product has been transferred to the customer. Those respondents commented that the customer does not receive a separate service if the warranty only protects the customer from the product defects that were present at the time of sale. Consequently, any subsequent repairs or replacements to remedy those defects are additional costs of providing the product and, therefore, relate to an entity's past performance.

- BC370 In the light of that feedback, the boards decided to account for some warranties differently from others. The boards considered distinguishing warranties on the basis of when the fault in the products arises; however, respondents explained that such a distinction was not operational. Therefore, the boards decided to distinguish warranties on the basis of whether the warranty provides the customer with a service in addition to the assurance that the related product complies with the agreed-upon specifications. Specifically, the boards decided that when the warranty provides a service (ie a service-type warranty), the warranty should be accounted for as a performance obligation.

Warranties that are performance obligations (service-type warranties)

- BC371 For some types of warranties, an entity either sells separately or negotiates separately with a customer so that the customer can choose whether to purchase the warranty coverage. That fact provides objective evidence that the promised warranty provides a service to the customer in addition to the promised product. Consequently, the boards decided that this type of promised warranty is a performance obligation in accordance with paragraphs 22–30 of IFRS 15.
- BC372 The boards decided that warranties that are not sold separately by the entity, or negotiated separately with the customer, should also be identified as performance obligations if the facts and circumstances suggest that the warranty (or a part of the warranty) provides a service to the customer, in addition to the assurance that the entity's past performance was as specified in the contract. The boards noted the following about this decision:
- (a) it provides a clear principle that allows an entity to account for economically similar warranties in a similar manner, regardless of whether the warranties are separately priced or negotiated;
 - (b) it is consistent with the general principles for identifying performance obligations; and
 - (c) it removes the bright line in previous US GAAP that distinguishes between different types of warranties based solely on whether the warranty is separately priced.
- BC373 A warranty that meets the requirements in paragraphs B28–B33 of IFRS 15 to be accounted for as a performance obligation might also meet the criteria for classification as an insurance contract. However, only warranties issued directly by a third party would be accounted for as insurance contracts according to the proposals in the boards' respective projects on the accounting for insurance contracts.

Warranties that are not performance obligations (assurance-type warranties)

- BC374 The boards considered whether an assurance-type warranty should be accounted for as either of the following:
- (a) a separate liability to replace or repair a defective product; or
 - (b) an unsatisfied performance obligation, because the entity has not provided the customer with a product that is free from defects at the time of sale.
- BC375 The proposals in the 2010 Exposure Draft would have required an entity that provides an assurance-type warranty to a customer to assess whether it had satisfied its performance obligation to transfer the product specified in the contract. The entity would have been required to determine the likelihood of the existence of defective products that it had sold to customers and their quantity and, as a consequence, not recognise revenue to the extent that those performance obligations were not satisfied. An advantage of that proposal would have been that an entity would not have recognised the entire transaction price as revenue when the product transferred to the customer, because a portion of the transaction price would not have been recognised as revenue until the entity had repaired or replaced the products that were expected to be defective. However, the boards decided not to retain that proposal, mainly for the following practical reasons:
- (a) there would have been complexities associated with the requirements for an entity to continue to recognise as 'inventory' products that had been delivered to customers and that were expected to be defective; and

- (b) any margin attributable to the repair or replacement of a product in an assurance-type warranty would have been unlikely to significantly distort the pattern of recognition of the overall contract margin.

BC376 Accordingly, the boards decided that an entity should recognise an assurance-type warranty as a separate liability to replace or repair a defective product. Consequently, an entity should recognise a warranty liability and corresponding expense when it transfers the product to the customer and the liability should be measured in accordance with IAS 37 or Topic 460 *Guarantees*. In contrast to the accounting for service-type warranties, an entity should not attribute any of the transaction price (and therefore revenue) to an assurance-type warranty. Some warranties may include both assurance features and service features. The boards decided that if an entity cannot reasonably account for those assurance features of the warranty separately from the service features, the entity should be allowed to account for the warranties together as a single performance obligation. That accounting ensures that the entity does not overstate the recognition of revenue at the time that the product transfers to the customer and also relieves the entity from identifying and accounting separately for the two components of the warranty coverage.

Statutory warranties

BC377 In some jurisdictions, the law requires an entity to provide warranties with the sale of its products. The law might state that an entity is required to repair or replace products that develop faults within a specified period from the time of sale. Consequently, those statutory warranties may appear to be service-type warranties because they cover faults arising after the time of sale, not merely defects existing at the time of sale. However, the boards decided that the law can be viewed as simply operationalising an assurance-type warranty. In other words, the objective of those statutory warranties is to protect the customer against the risk of purchasing a defective product. But rather than requiring the entity to determine whether the product was defective at the time of sale, the law presumes that if a fault arises within a specified period (which can vary depending on the nature of the product), the product was defective at the time of sale. Consequently, these statutory warranties should be accounted for as assurance-type warranties.

Product liability laws

BC378 The boards clarified that product liability laws do not give rise to performance obligations. Those laws typically require an entity to pay compensation if one of its products causes harm or damage. The boards noted that an entity should not recognise a performance obligation arising from those laws because the performance obligation in a contract is to transfer the product to the customer. To the extent that an entity expects the product(s) to be defective, the entity should recognise a liability for the expected costs to repair or replace the product (see paragraph B33 of IFRS 15). Any obligation of the entity to pay compensation for the damage or harm that its product causes is separate from the performance obligation. The boards noted that an entity should account for this obligation separately from the contract with the customer and in accordance with the requirements for loss contingencies in IAS 37 or Topic 450.

Principal versus agent considerations (paragraphs B34–B38)⁵

BC379 Previous revenue Standards required an entity to assess whether it was acting as a principal or an agent when goods or services were transferred to a customer. That assessment was necessary to determine whether an entity should recognise revenue for the gross amount of customer consideration (if the entity was determined to be a principal) or for a net amount after the supplier was compensated for its goods or services (if the entity was determined to be an agent).

⁵ *Clarifications to IFRS 15* issued in April 2016 amended the application guidance in paragraphs B34–B38 and, as a consequence, amended paragraph BC383. The objective of amending the application guidance in paragraphs B34–B38 is to (a) provide a better framework to be applied when assessing whether an entity is a principal or an agent; (b) clarify the application of the control principle to intangible goods and services; and (c) clarify the role of the indicators in paragraph B37 when applying the control principle. Paragraphs BC379–BC385 should therefore be read together with paragraphs BC385A–BC385Z, which explain the boards' considerations for amending the application guidance.

- BC380 IFRS 15 also requires an entity to determine whether it is a principal or an agent. This is because the performance obligations of principals and agents are different. A principal controls the goods or services before they are transferred to a customer. Consequently, the principal's performance obligation is to transfer those goods or services to the customer. Therefore, recognising revenue at the gross amount of the customer consideration faithfully depicts the consideration to which the entity is entitled for the transfer of the goods and services. In contrast, an agent does not control the goods or services before they are transferred to a customer. The agent merely facilitates the sale of goods or services between a principal and the customer. Consequently, an agent's performance obligation is to arrange for another party to provide the goods or services to the customer. Therefore, the transaction price attributable to an agent's performance obligation is the fee or commission that the agent receives for providing those services.
- BC381 The boards observed that identifying an entity's promise (ie the performance obligation) in a contract is fundamental to the determination of whether the entity is acting as a principal or an agent. This is because identifying the nature of the entity's performance obligation is necessary for the entity to determine whether it controls the goods or services that have been promised before they are transferred to a customer. For example, a travel agent could be the principal in some contracts with customers if the travel agent determines that its promise is to provide a right to a flight (ie a ticket), instead of a promise to provide the flight. However, to conclude whether they are a principal or an agent, the travel agent would need to also consider whether it controlled that right before transferring it to the customer, which may occur when the travel agent purchases the tickets in advance for sales to future customers.
- BC382 The nature of the entity's promise may not always be readily apparent. For that reason, the boards included indicators in paragraph B37 of IFRS 15 to help an entity determine whether the entity controls the goods or services before transferring them and thus whether the entity is a principal or an agent. Those indicators are based on indicators that were included in previous revenue recognition requirements in IFRS and US GAAP. However, as noted in paragraph BC380, the indicators in IFRS 15 have a different purpose than previous revenue recognition requirements in that they are based on the concepts of identifying performance obligations and the transfer of control of goods or services.
- BC383 After an entity identifies its promise and determines whether it is the principal or the agent, the entity would recognise revenue when it satisfies its performance obligation. This would, for an entity that is a principal, occur when control of the promised goods or services transfers to the customer. The boards observed that in some contracts in which the entity is the agent, control of the goods or services promised to the customer might transfer before the customer receives the goods or services from the principal. For example, an entity that issues loyalty points to its customers when they purchase goods or services from the entity might satisfy its performance obligation with respect to the loyalty points on issuing those points to the customers if:
- (a) the points entitle the customers to future discounted purchases with another party (ie the points represent a material right to a future discount); and
 - (b) the entity determines that it is an agent (ie its promise is to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer.
- BC384 In contrast, the boards observed that if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services and thus the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

BC385 In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. The boards observed that in those cases, to determine when the performance obligation is satisfied, the entity would need to consider the nature of its performance obligation. This is because until the customer has chosen the goods or services to be provided (and thus whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Thus, the entity may not satisfy its performance obligation until such time as it either delivers the goods or services or is no longer obliged to stand ready. The boards also observed that if the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent and thus should recognise revenue for only a fee or commission that the entity received from providing the services to the customer and the third party. The boards noted that this is consistent with previous revenue recognition requirements in IFRS for customer loyalty programmes.

Clarifications to IFRS 15 (amendments issued in April 2016)

BC385A The TRG discussed a number of issues in relation to paragraphs B34–B38 of IFRS 15. Some stakeholders asked whether control is always the basis for determining whether an entity is a principal or an agent, and how the control principle and the indicators in paragraph B37 work together. Other stakeholders asked how to apply the control principle to contracts involving intangible goods or services. In the light of those discussions and the feedback received, the boards discussed, and decided to clarify, the principal versus agent guidance by making the same targeted amendments to the application guidance and the related Illustrative Examples in IFRS 15 and Topic 606.

BC385B When another party is involved in providing goods or services to a customer, the amendments to the application guidance clarify how an entity determines whether it is a principal or an agent. These amendments focus on (a) the need for appropriately identifying the good or service that is transferred to the customer (the ‘specified good or service’); and (b) determining whether the entity has promised to provide the specified good or service itself (ie the entity is a principal) or to arrange for the specified good or service to be provided to the customer by the other party (ie the entity is an agent). The entity determines the nature of its promise on the basis of whether the entity controls the specified good or service before that good or service is transferred to the customer. Throughout the guidance on principal versus agent considerations, the boards decided to refer to the *specified good or service* transferred to the customer (as in paragraph B34), rather than the *performance obligation*. This is because use of the term ‘performance obligation’ would have been confusing if the entity is an agent. An agent’s performance obligation is to arrange for the other party to provide its goods or services to the customer; it does not promise to provide the goods or services itself to the end customer. Accordingly, the specified good or service to be provided to the end customer is not the performance obligation of the agent.

Principle for determining whether an entity is a principal or an agent

BC385C Paragraph B34 requires an entity to determine whether it is a principal or an agent on the basis of whether the nature of the entity’s promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by another party (ie the entity is an agent). Assessing whether the entity controls the specified good or service before it is transferred to the customer is the basis for determining the nature of the entity’s promise.

BC385D The boards observed that in order for an entity to conclude that it is providing the specified good or service to the customer, it must first control that good or service (as defined in paragraph 33). The entity cannot provide the specified good or service to a customer if the entity does not first control the good or service to be provided. If an entity controls the specified good or service before that good or service is transferred to the customer, the entity is the principal in the transaction with the customer. If the entity does not control the specified good or service before that good or service is transferred to a customer, the entity is not a principal in the transaction with the customer. The boards noted that their considerations in this respect are explained in paragraph BC380.

BC385E In addition, the boards noted that an entity that itself manufactures a good or performs a service is always a principal if the entity transfers control of that good or service to another party. Such an entity does not need to evaluate whether it is a principal or an agent using the guidance in

paragraphs B34–B38 because the entity transfers the good or provides the service directly to its customer, without the involvement of another party. If the entity transfers a good or provides a service to an intermediary that is a principal in providing that good or service to an end customer (whether individually or as part of a distinct bundle of goods or services), the entity's customer is the intermediary.

BC385F Because of the concerns highlighted in the TRG's discussions, the boards decided to clarify the following aspects of the application guidance on principal versus agent considerations:

- (a) the relationship between the control principle and the indicators in paragraph B37; and
- (b) the application of the control principle to intangible goods and services.

The relationship between control and the indicators in paragraph B37

BC385G The boards observed that the questions about the relationship between the assessment of control and the indicators of control in paragraph B37 arose, at least in part, because the indicators in that paragraph were carried forward from IAS 18 *Revenue* and Topic 605 *Revenue Recognition*. IAS 18 had a principle for this assessment (based on risks and rewards) that was different from the control principle in IFRS 15 and, although Topic 605 did not explicitly include a principle, the indicators in Topic 605 were understood to be indicators of risks and rewards. In addition, the structure of the analysis in Examples 45–48 accompanying IFRS 15 added to the confusion.

BC385H The boards' considerations (explained in paragraph BC382) highlight that the indicators in paragraph B37 were included to support an entity's assessment of whether it controls a specified good or service before transfer in scenarios for which that assessment might be difficult. The indicators (a) do not override the assessment of control; (b) should not be viewed in isolation; (c) do not constitute a separate or additional evaluation; and (d) should not be considered a checklist of criteria to be met, or factors to be considered, in all scenarios. Considering one or more of the indicators will often be helpful and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control.

BC385I The boards acknowledged that the indicators are similar to those in IAS 18 and Topic 605, but also noted their considerations in this respect, explained in paragraph BC382. Paragraph BC382 explains that the boards decided to carry over some of the indicators in previous revenue recognition Standards even though those indicators have a different purpose in IFRS 15. In IFRS 15, the indicators support the concepts of identifying performance obligations and the transfer of control of goods or services. Accordingly, the boards had expected that the conclusions about principal versus agent under IFRS 15 could be different in some scenarios from those reached under the previous revenue recognition Standards. Furthermore, the boards observed that, although exposure to risks and rewards alone does not give an entity control, exposure to risks and rewards can be a helpful factor to consider in determining whether an entity has obtained control (see paragraph 38).

BC385J The boards decided to amend the indicators in paragraph B37 to more clearly establish a link between the control principle and the indicators by:

- (a) reframing the indicators as indicators of when an entity controls a specified good or service before transfer, rather than as indicators that an entity does not control the specified good or service before transfer.
- (b) adding guidance to explain how each indicator supports the assessment of control as defined in paragraph 33 of IFRS 15. This should help entities apply indicators that are similar to those in the previous revenue recognition Standards but within the context of the control principle in IFRS 15.
- (c) removing the indicator relating to the form of the consideration. Although that indicator might sometimes be helpful in assessing whether an entity is an agent, the boards concluded that it would not be helpful in assessing whether an entity is a principal.
- (d) removing the indicator relating to exposure to credit risk. The feedback on the Exposure Draft *Clarifications to IFRS 15* highlighted that exposure to credit risk is generally not a

helpful indicator when assessing whether an entity controls the specified good or service. Stakeholders observed that the credit risk indicator in the previous revenue guidance has been problematic from the perspective of entities trying to use exposure to credit risk to override stronger evidence of agency. The boards concluded that removing the credit risk indicator should reduce some of the complexity in the principal versus agent evaluation because the credit risk indicator will typically be less relevant, or not relevant, to the evaluation for contracts within the scope of IFRS 15.

- (e) clarifying that the indicators are not an exhaustive list and merely support the assessment of control—they do not replace or override that assessment. The boards decided to explicitly state that one or more of the indicators might provide more persuasive evidence to support the assessment of control in different scenarios.

BC385K In the light of the IASB's decision to generally apply a high hurdle when considering whether to amend IFRS 15, the IASB initially thought that it would not be necessary to add explanatory text to each indicator in paragraph B37 to establish a link to the concept of control. In the IASB's view, clarity about the interaction between the control principle and the indicators could have been achieved by amending only the Illustrative Examples. The IASB noted concerns about adding explanatory text to the indicators in paragraph B37 because of (a) the risk of new questions arising with respect to those additional explanations; and (b) the risk that some of those additional explanations might be used inappropriately to reach a conclusion that an entity is a principal when the entity is an agent. Nonetheless, despite those concerns, the IASB decided to amend the indicators in paragraph B37 of IFRS 15 in order to align the wording of the amendments with the wording of those made by the FASB. The IASB concluded that the benefits of retaining converged requirements on this topic outweigh the potential costs of amending the requirements.

The use of the indicators in paragraph B37 rather than the indicators in paragraph 38

BC385L Some stakeholders asked why the indicators in paragraph B37 are different from the indicators on the satisfaction of performance obligations (paragraph 38), noting that both sets of indicators relate to control. The boards observed that the indicators in paragraph 38 are indicators of the point in time at which the customer obtains control of the promised good or service. Accordingly, the indicators in paragraph 38 serve a different purpose than the indicators in paragraph B37. The indicators in paragraph 38 are not intended to indicate whether the customer obtains control of a promised asset—within the context of IFRS 15 as a whole, it is assumed that the customer will obtain control of the promised asset at some point—instead, they are intended to indicate when the customer has obtained control. In contrast, the indicators in paragraph B37 are intended to indicate whether the entity controls a specified good or service before that good or service is transferred to the customer.

Application of the control principle to intangible goods and services

BC385M The boards observed that at least some of the difficulty that stakeholders had in applying the control principle, in particular to intangible goods and services, was linked to challenges in identifying the specified good or service to be provided to the customer. The boards observed that this also had frequently been a challenge for entities under previous revenue recognition Standards.

BC385N The principal versus agent considerations relate to the application of Step 2 of the revenue recognition model. Appropriately identifying the good or service to be provided is a critical step in appropriately identifying whether the nature of an entity's promise is to act as a principal or an agent. When the appropriate specified good or service is identified, the assessment of control is often relatively straightforward, even when the specified good or service is an intangible good or a service. For example, the specified good or service to be provided to the customer could be:

- (a) a right to goods or services (see paragraph 26). For example, the airline ticket (a right to fly) in Example 47 and the meal voucher (a right to a meal) in Example 48 accompanying IFRS 15; or
- (b) a bundle of goods or services that are not distinct from each other (for example, the specialised equipment in Example 46 accompanying IFRS 15).

BC385O The boards observed that when the specified good or service to be provided to the customer is a right to goods or services to be provided in the future by another party, the entity would determine whether its performance obligation is a promise to provide a right to goods or services or whether it is arranging for the other party to provide that right. The fact that the entity will not provide the goods or services itself is not determinative. Instead, the entity evaluates whether it controls the right to goods or services before that right is transferred to the customer. In doing so, it is often relevant to assess whether the right is created only when it is obtained by the customer, or whether the right to goods or services exists before the customer obtains the right. If the right does not exist before the customer obtains it, an entity would be unable to control that right before it is transferred to the customer.

BC385P Some respondents to the Exposure Draft stated that it could be difficult in some cases to determine whether the specified good or service is the right to a good or service to be provided by another party or the underlying good or service itself (for example, in the case of Example 47, whether the specified good or service is the right to the flight (the ticket) or the flight itself). The boards observed that a careful consideration of the facts and circumstances, and exercise of judgement may be required in identifying the specified good or service (just as identifying an entity's performance obligations outside the context of a principal versus agent evaluation will often require judgement). The boards also observed that assessing whether an entity controls a right to a good or service to be provided by another party is important to the principal versus agent evaluation. The boards noted that the Illustrative Examples accompanying IFRS 15 on principal versus agent considerations have been designed to address and explain scenarios in which the specified good or service is a right to a good or service to be provided by another party (as in Example 47 accompanying IFRS 15) and scenarios in which the specified good or service is the underlying service itself (as in Example 46A accompanying IFRS 15).

BC385Q The boards also observed that the specified good or service to which the control principle is applied should be a distinct good or service, or a distinct bundle of goods or services. If individual goods or services are not distinct from each other, then they may be, for example, merely inputs to a combined item and are each only part of a single promise to the customer. Accordingly, an entity should evaluate the nature of its promise (ie to act as a principal or an agent) within the context of the promise to the customer, rather than for part of that promise. Consequently, for contracts in which goods or services provided by another party are inputs to a combined item (or items) for which the customer has contracted, the entity assesses whether it controls the combined item before that item is transferred to the customer.

BC385R When a specified good or service is a distinct bundle of goods or services, the principal versus agent analysis may, in some cases, be straightforward. The boards concluded (in paragraph B35A(c)) that when an entity provides a significant service of integrating two or more goods or services into the combined output that is the specified good or service for which the customer contracted, it controls that specified good or service before it is transferred to the customer. When the entity provides a significant integration service it controls the inputs to the combined item that is the specified good or service (including goods or services provided by another party that are inputs to the specified good or service). The entity controls the inputs by directing their use to create the combined item. In that case, the inputs provided by the other party would be a fulfilment cost to the entity. In contrast, if a third party provides the significant integration service, then the entity's customer for its goods or services (which would be inputs to the specified good or service) is likely to be the other party.

BC385S Consequently, the boards decided to clarify the thought process to be applied when assessing whether an entity is a principal or an agent by specifically requiring an entity to identify the specified good or service before applying the control principle to each specified good or service. The amended paragraph B34 and the additional paragraph B34A should:

- (a) provide a better framework for assessing whether an entity is a principal or an agent.
- (b) emphasise the importance of appropriately identifying the specified good or service (which could be a right to a good or service to be provided by another party) that will be transferred to the customer.
- (c) clarify that the specified good or service (ie the unit of account for the principal versus agent evaluation) is each distinct good or service (or distinct bundle of goods or services). Accordingly, those paragraphs also clarify that, because a contract with a customer could

include more than one specified good or service, an entity could be a principal for one or more specified goods or services in a contract and an agent for others.

- (d) emphasise that control (as defined in paragraph 33 of IFRS 15) is the determining factor when assessing whether an entity is a principal or an agent.

BC385T The IASB noted that, in many respects, paragraph B34A simply points to other relevant parts of the requirements in IFRS 15. Accordingly, the IASB did not view the inclusion of that additional paragraph as essential to clarifying the requirements in IFRS 15. In its view, clarity about the thought process to be applied could have been achieved by amending only the Illustrative Examples. Nonetheless, given the concerns raised by stakeholders, the IASB concluded that including paragraph B34A would be helpful to the principal versus agent evaluation, and would align the wording of the amendments with the wording of those made by the FASB. Therefore, the IASB concluded that the benefits of adding the paragraph outweigh the potential costs of amending the requirements.

Assessment of control of a service

BC385U The TRG's discussions highlighted concerns about the application of the control principle to services to be provided to a customer. Questions discussed included how an entity (other than the service provider) could control a service before that service is transferred to the customer, because a service comes into existence only at the moment that it is delivered. The boards observed that an entity can control a service to be provided by another party when it controls the right to the specified service from the other party that will be provided to the customer. The entity then either transfers the right to the service to the customer (for example, the airline ticket in Example 47) or uses its right to direct the other party to provide the service to the customer on the entity's behalf (ie to satisfy the entity's performance obligation in the contract with the customer), such as in Example 46A. Determining whether the entity controls a right to a specified service requires consideration of the facts and circumstances. The boards noted that contracts involving services provided by another party in which the entity is a principal can be broadly categorised as follows:

- (a) Contracts in which an entity provides the customer with a right to a future service to be provided by another party, such as the right to a specified flight (in the form of a ticket) to be provided by an airline (as discussed in paragraph BC385O).
- (b) Contracts in which the service provided by the other party is not distinct from other goods or services promised to the customer, and the entity directs the use of that service to create the combined item that is the specified good or service for which the customer has contracted (as discussed in paragraphs BC385Q–BC385R). Paragraph B35A(c) states that this scenario would exist whenever the entity provides a significant service of integrating the service provided by another party into the specified good or service for which the customer has contracted. Example 46 accompanying IFRS 15 illustrates this scenario.
- (c) Contracts in which an entity directs another party to provide the service to the customer on the entity's behalf in satisfying the entity's performance obligation. Example 46A accompanying IFRS 15 illustrates this scenario.

BC385V The boards observed that determining whether an entity is a principal or an agent may be more difficult in the third category of contracts listed above in which the entity has entered into a contract with a customer and has engaged another party (a subcontractor) to satisfy a performance obligation within that contract on its behalf. In these contracts, the entity assesses whether it controls a right to the specified services. An entity could control the right to the specified services by entering into a contract with the subcontractor and defining the services to be performed by the subcontractor on the entity's behalf. In that scenario, which is illustrated in Example 46A, the entity obtains the right to the services of the subcontractor and then directs the subcontractor to provide the services to the customer on the entity's behalf. This scenario is equivalent to the entity fulfilling the contract using its own resources rather than engaging another party to do so. The entity would remain responsible for the satisfactory provision of services in accordance with the contract with the customer. In other scenarios in which the specified services provided to the customer are provided by another party and the entity did not have the ability to direct those services, the entity would typically be an agent. In those scenarios, the entity is likely to be facilitating (and arranging

for) the provision of services by the other party rather than controlling the rights to the services that the entity then directs to the customer.

BC385W The boards noted that paragraph B35 explains that an entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party to satisfy some or all of a performance obligation on its behalf. The boards decided to add further explanation (paragraph B35A) to clarify the assessment of control of a service by explaining the scenarios in which a principal can control a service to be provided by another party. The boards also decided to add Example 46A to the Illustrative Examples accompanying IFRS 15 to illustrate the application of control to services.

Estimating revenue as a principal

BC385X Some TRG participants asked how an entity that is a principal would estimate the amount of revenue to recognise if it were not aware of the amounts being charged to end customers by an intermediary that is an agent. The IASB observed that this question is largely unrelated to the application guidance on principal versus agent considerations in paragraph B34–B38 of IFRS 15, but rather relates to applying the requirements in paragraphs 46–90 on determining the consideration to which an entity is entitled. The IASB noted that the situations in which an entity that is a principal may be unaware of the amount charged to end customers by an intermediary that is an agent are generally limited to situations in which the intermediary (a) has some flexibility in setting prices; or (b) is procuring the good or service on behalf of the end customer. The IASB concluded that the issue does not require any clarifications or additional guidance because the issue is expected to affect a limited number of entities and contracts.

BC385Y The FASB has also decided not to amend Topic 606 to address this issue. This is mainly because the FASB had observed that the situations in which an entity that is a principal is (and expects to remain) unaware of the amount charged by an intermediary that is an agent to the end customer are not pervasive and the issue affects only a limited number of entities and contracts. For those limited situations, the FASB is of the view that the determination of whether revenue may be estimated is based on an assessment of the requirements for determining the transaction price and estimating variable consideration.

BC385Z The IASB did not specifically consider how the transaction price requirements would be applied in those situations but concluded that an entity that is a principal would generally be expected to be able to apply judgement and determine the consideration to which it is entitled using all relevant facts and circumstances available to it.

Customer options for additional goods or services (paragraphs B39–B43)

BC386 In some contracts, customers are given an option to purchase additional goods or services. The boards considered when those options should be accounted for as a performance obligation. During those discussions, the boards observed that it can be difficult to distinguish between the following:

- (a) an option that the customer pays for (often implicitly) as part of an existing contract, which would be a performance obligation to which part of the transaction price is allocated; and
- (b) a marketing or promotional offer that the customer did not pay for and, although made at the time of entering into a contract, is not part of the contract and that would not be a performance obligation in that contract.

BC387 Similar difficulties in distinguishing between an option and an offer have arisen in US GAAP for the software industry. Previous US GAAP revenue recognition requirements for the software industry specified that an offer of a discount on future purchases of goods or services was presumed to be a separate option in the contract, if that discount was significant and also incremental both to the range of discounts reflected in the pricing of other elements in that contract and to the range of discounts typically given in comparable transactions. Those notions of 'significant' and 'incremental' form the basis for the principle of a material right that is used to differentiate between an option and a marketing or promotional offer. However, the boards observed that even if the offered discount is not incremental to other discounts in the contract, it nonetheless could, in some cases, give rise to

a material right to the customer. Consequently, the boards decided not to carry forward that part of the previous revenue recognition requirements from US GAAP into IFRS 15.

- BC388 Some respondents asked the boards to clarify whether specific options, such as customer loyalty points, should be accounted for as a performance obligation when the arrangement involves more than two parties. This often occurs in a credit card arrangement in which an entity provides the credit card holder with points based on the amount of purchases made at other entities (often referred to as 'merchants'). The boards determined that the assessment of whether any loyalty points represent a performance obligation requires an analysis of the facts and circumstances in each arrangement. The boards decided not to provide any further guidance because the issue was specific to the credit card industry and the boards observed that these arrangements are often complex and can vary significantly. Furthermore, the boards noted that IFRS 15 includes all the requirements to enable entities to account for the various arrangements.

Allocating the transaction price

- BC389 In accordance with IFRS 15, an entity is required to determine the stand-alone selling price of the option so that it can allocate part of the transaction price to that performance obligation. In some cases, the stand-alone selling price of the option may be directly observable. In many cases though, the stand-alone selling price of the option will need to be estimated.
- BC390 Option pricing models can be used to estimate the stand-alone selling price of an option. The price of an option includes the intrinsic value of the option (ie the value of the option if it were exercised today) and its time value (ie the value of the option that depends on the time until the expiry and the volatility of the price of the underlying goods or services). The boards decided that the benefits to users of financial statements of allocating some of the transaction price to the price and availability guarantees inherent in the time value component of the option price would not have justified the costs and difficulties to do so. However, the boards decided that an entity should be able to readily obtain the inputs necessary to measure the intrinsic value of the option in accordance with paragraph B42 of IFRS 15 and that those calculations should be relatively straightforward and intuitive. This measurement approach is consistent with the application guidance that was provided for measuring customer loyalty points in previous revenue recognition requirements in IFRS.

Renewal options

- BC391 A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract.
- BC392 However, there are typically a series of options in cases in which a renewal option provides a customer with a material right. In other words, to exercise any option in the contract, the customer must have exercised all the previous options in the contract. The boards decided that determining the stand-alone selling price of a series of options would have been complex because doing so would have required an entity to identify various inputs, such as the stand-alone selling prices for the goods or services for each renewal period and the likelihood that the customers will renew for the subsequent period. In other words, the entity would have had to consider the entire potential term of the contract to determine the amount of the transaction price from the initial period that should be deferred until later periods.
- BC393 For that reason, the boards decided to provide an entity with a practical alternative to estimating the stand-alone selling price of the option. The practical alternative requires an entity to include the optional goods or services that it expects to provide (and corresponding expected customer consideration) in the initial measurement of the transaction price. In the boards' view, it is simpler for an entity to view a contract with renewal options as a contract for its expected term (ie including the expected renewal periods) rather than as a contract with a series of options.

- BC394 The boards developed two criteria to distinguish renewal options from other options to acquire additional goods or services. The first criterion specifies that the additional goods or services underlying the renewal options must be similar to those provided under the initial contract—that is, an entity continues to provide what it was already providing. Consequently, it is more intuitive to view the goods or services underlying such options as part of the initial contract. In contrast, customer loyalty points and many discount vouchers should be considered to be separate deliverables in the contract, because the underlying goods or services may be of a different nature.
- BC395 The second criterion specifies that the additional goods or services in the subsequent contracts must be provided in accordance with the terms of the original contract. Consequently, the entity's position is restricted because it cannot change those terms and conditions and, in particular, it cannot change the pricing of the additional goods or services beyond the parameters specified in the original contract. That too is different from examples such as customer loyalty points and discount vouchers. For example, if an airline offers flights to customers in exchange for points from its frequent flyer programme, the airline is not restricted, because it can subsequently determine the number of points that are required to be redeemed for any particular flight. Similarly, when an entity grants discount vouchers, it has typically not restricted itself with respect to the price of the subsequent goods or services against which the discount vouchers will be redeemed.

Customers' unexercised rights (breakage) (paragraphs B44–B47)

- BC396 Some respondents asked the boards to provide guidance on how to account for a customer's non-refundable prepayment for the right to receive goods or services in the future. Common examples include the purchase of gift cards and non-refundable tickets.
- BC397 The boards noted that the requirements for the allocation of the transaction price to customer options implicitly explains how to account for situations in which the customer does not exercise all of its contractual rights to those goods or services (ie breakage). However, the boards decided to clarify how to account for breakage in situations in which there is only one performance obligation in the contract (ie how to account for breakage in customer options when there is no need to allocate the transaction price and, therefore, no need to determine a stand-alone selling price).
- BC398 Consequently, the boards included application guidance on the accounting for breakage. Those requirements require the same pattern of revenue recognition as the requirements for customer options. Thus, an entity should recognise revenue from breakage as it performs under the contract on the basis of the transfer of the goods or services promised in the contract. This effectively increases the transaction price allocated to the individual goods or services transferred to the customer to include the revenue from the entity's estimate of unexercised rights. The boards decided that this approach represents the most appropriate pattern of revenue recognition for breakage, because if an entity expected that customers would exercise all of their rights (ie if the entity did not expect any breakage), it might increase the price of its goods or services. For example, an airline that sells non-refundable tickets would presumably charge a higher price per ticket if there was no expectation of breakage.
- BC399 The boards also decided that an entity should recognise revenue for breakage only if it is highly probable that doing so would not result in a subsequent significant revenue reversal (see paragraphs 56–58 of IFRS 15). Otherwise, the entity's performance obligation to stand ready to provide future goods or services could be understated.
- BC400 The boards considered but rejected an approach that would have required an entity to recognise estimated breakage as revenue immediately on the receipt of prepayment from a customer. The boards decided that because the entity has not performed under the contract, recognising revenue would not have been a faithful depiction of the entity's performance and could also have understated its obligation to stand ready to provide future goods or services.
- BC401 Some respondents questioned whether the accounting for breakage is consistent with that for customer options in IFRS 15. Those respondents explained that for customer options, breakage is taken into account when determining the stand-alone selling price of the option as required by paragraph B42 of IFRS 15. Therefore, those respondents were concerned that when the consideration is allocated between the option and another performance obligation, some of the breakage on the option would be recognised when the other performance obligation is satisfied, which could occur before any rights under the options are exercised by the customer. However, the

boards observed that when there are two (or more) performance obligations, IFRS 15 requires an entity to allocate the overall consideration between the performance obligations based on their relative stand-alone selling prices and, therefore, any discount on the combined bundle of goods or services is allocated on that basis (unless the entity meets the requirements in paragraph 82 or 85 of IFRS 15 to allocate on another basis). In other words, any difference between the sum of the stand-alone selling prices of the option and the other promised goods or services compared with the overall consideration would be recognised when (or as) the entity transfers the goods or services promised in the contract, which is consistent with the pattern of revenue recognition for breakage when there is only one performance obligation.

Licensing (paragraphs B52–B63B)⁶

- BC402 In the 2011 Exposure Draft, the boards proposed that a licence grants a customer a right to use, but not own, intellectual property of the entity. Consequently, the 2011 Exposure Draft viewed the nature of the promised asset in a licence as a right to use an intangible asset that is transferred at a point in time. This is because the boards' view at that time was that there is a point at which the customer obtains the ability to direct the use of, and obtain substantially all of the benefits from, the right to use the intellectual property. However, the 2011 Exposure Draft also explained that revenue may be recognised over time for some contracts that include a licence if that licence is not distinct from other promises in the contract that may transfer to the customer over time.
- BC403 In the light of the feedback received on the 2011 Exposure Draft, the boards reconsidered whether the nature of the promised asset in a licence is always a right that transfers at a point in time. In the examples they considered, the boards observed that licences vary significantly and include a wide array of different features and economic characteristics, which lead to significant differences in the rights provided by a licence. In some of the examples, the boards observed that the customer might be viewed as not obtaining control of the licence at a point in time. This is because the intellectual property to which the customer has obtained rights is dynamic and will change as a result of the entity's continuing involvement in its intellectual property, including activities that affect that intellectual property. In those cases, the customer may not be able to direct the use of, and obtain substantially all of the remaining benefits from, the licence at the time of transfer. In other words, what the licence provides to the customer is access to the intellectual property in the form in which it exists at any given moment. (Those notions were supported by some respondents who opposed the proposal in the 2011 Exposure Draft that all distinct licences represent the transfer of a right to use an intangible asset.)
- BC404 Consequently, the boards decided to specify criteria for determining whether the nature of the entity's promise in granting a licence is to provide a customer with a right to access the entity's intellectual property as it exists throughout the licence period, or a right to use the entity's intellectual property as it exists at a point in time when the licence is granted. The boards noted that these criteria were necessary to distinguish between the two types of licences, rather than strictly relying on the control requirements, because it is difficult to assess when the customer obtains control of assets in a licence without first identifying the nature of the entity's performance obligation.
- BC405 However, the boards observed that before applying the criteria, an entity should assess the goods or services promised in the contract and identify, as performance obligations, the promises that transfer the goods or services to the customer.

Identifying the performance obligations

- BC406 The boards observed that, as is the case with other contracts, contracts that include a licence require an assessment of the promises in the contract and the criteria for identifying performance obligations (see paragraphs 27–30 of IFRS 15). This would include an assessment of whether the customer can benefit from the licence on its own or together with other resources that are readily available (see paragraph 27(a) of IFRS 15) and whether the licence is separately identifiable from other goods or services in the contract (see paragraph 27(b) of IFRS 15). The boards observed that this assessment may sometimes be challenging because the customer can often obtain

⁶ *Clarifications to IFRS 15* issued in April 2016 deleted paragraph B57 and added paragraph B59A of IFRS 15 to clarify the application guidance on determining the nature of the entity's promise in granting a licence of intellectual property. Paragraphs BC402–BC414 should therefore be read together with paragraphs BC414A–BC414Y, which explain the IASB's considerations in amending the application guidance.

benefit from the licence on its own (ie the licence is capable of being distinct). However, in many cases, the customer can benefit from the licence only with another good or service that is also promised (explicitly or implicitly) in the contract; therefore, the licence is not separately identifiable from other goods or services in the contract. This may occur when:

- (a) a licence forms a component of a tangible good and is integral to the good's functionality—software (ie a licence) is often included in tangible goods (for example, a car) and in most cases, significantly affects how that good functions. In those cases, the customer cannot benefit from the licence on its own (see paragraph 27(a) of IFRS 15) because the licence is integrated into the good (see paragraph 29(a) of IFRS 15); that is, the licence is an input to produce that good, which is an output.
- (b) a licence that the customer can benefit from only in conjunction with a related service—this may occur when an entity provides a service, such as in some hosting or storage services, that enables the customer to use a licence, such as software, only by accessing the entity's infrastructure. In those cases, the customer does not take control of the licence and, therefore, cannot benefit from (or use) the licence on its own (see paragraph 27(a) of IFRS 15) without the hosting service. In addition, the use of the licence is highly dependent on, or highly interrelated with, the hosting service (see paragraph 29(c) of IFRS 15).

BC407 If the customer cannot benefit from the licence on its own, and/or the licence cannot be separated from other promises in the contract, the licence would not be distinct and thus would be combined with those other promises (see paragraph 30 of IFRS 15). The entity would then determine when the single performance obligation is satisfied on the basis of when the good or service (ie the output) is transferred to the customer. The boards noted that in some cases the combined good or service transferred to the customer may have a licence as its primary or dominant component. When the output that is transferred is a licence or when the licence is distinct, the entity would apply the criteria in paragraph B58 of IFRS 15 to determine whether the promised licence provides the customer with access to the entity's intellectual property or a right to use the entity's intellectual property.

Developing the criteria for licences that provide a right to access

BC408 As noted in paragraph BC404, the boards decided to specify criteria in paragraph B58 of IFRS 15 for determining if the intellectual property will change and, thus, if a licence provides a customer with a right to access the entity's intellectual property. If those criteria are not met, the licence provides the customer with a right to use an entity's intellectual property as that intellectual property exists (in the form and with the functionality) at the point in time when the licence transfers to the customer. To ensure that all licences are accounted for as either a right of access or a right to use, the boards decided to specify criteria for only one type of licence. In determining for which type of licence they should develop criteria, the boards observed that it was easier to determine when the intellectual property to which the customer has rights was changing (ie was dynamic), rather than when it was static.

BC409 In developing the criteria, the boards observed that the main factor that results in the intellectual property changing is when the contract requires, or the customer reasonably expects, that the entity undertakes activities that do not directly transfer goods or services to a customer (ie they do not meet the definition of a performance obligation). The activities may be part of an entity's ongoing and ordinary activities and customary business practices. However, the boards noted that it was not enough that the entity undertook activities, but also that those activities affected the intellectual property to which the customer has rights and, thus, exposes the customer to positive or negative effects. In those cases, the customer will essentially be using the most recent form of the intellectual property throughout the licence period. The boards observed that when the activities do not affect the customer, the entity is merely changing its own asset, which, although it may affect the entity's ability to provide future licences, would not affect the determination of what the licence provides or what the customer controls.

BC410 The boards noted that the assessment of the criteria would not be affected by other promises in the contract to transfer goods or services (ie performance obligations) that are separate from the licence. This is because the nature and pattern of transfer of each (separate) performance obligation in a contract would not affect the timing of other promised goods or services in the contract and, thus, would not affect the identification of the rights provided by the licence. This is

because, by definition, a performance obligation is separate from the other promises in the contract. Consider a contract to provide a car and ongoing maintenance services—that is, two distinct goods or services (and thus two separate performance obligations). In this case, it seems counterintuitive to include the promise to provide a (separate) maintenance service when determining the nature and timing of the entity's performance related to the transfer of the car. A similar example can be drawn from a contract that includes a software licence and a promise to provide a service of updating the customer's software (sometimes included in a contract as post-contract support), in which the post-contract support is identified as a distinct good or service. This is because the entity would not consider the post-contract support when determining when control of the software transfers to the customer. In other words, a promise to transfer separate updates to the licence would not be considered in the assessment of the criteria in paragraph B58 of IFRS 15 and, furthermore, would be specifically excluded by criterion (c) in that paragraph.

BC411 The boards also noted that an entity would exclude the factors specified in paragraph B62 of IFRS 15 for the following reasons:

- (a) restrictions of time, geographical region or use that define the attributes of the asset conveyed in a licence—an entity would not consider restrictions of time, geographical region or use, because they define attributes of the rights transferred rather than the nature of the underlying intellectual property and the rights provided by the licence. Consider, for example, a term licence that permits the customer to show a movie in its theatre six times over the next two years. The restrictions in that example determine the nature of the asset that the entity has obtained (ie six showings of the movie), rather than the nature of the underlying intellectual property (ie the underlying movie).
- (b) guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend and maintain that patent—guarantees that the entity has a valid patent would not be included in the assessment of the criteria for determining the rights provided in a licence, because those promises are part of the entity's representation that the intellectual property is legal and valid (this notion was previously included in the 2011 Exposure Draft).

BC412 In developing the criteria, the boards considered, but rejected, differentiating licences based on the following factors:

- (a) term of the licence—the length of a licence term is a restriction that represents an attribute of the asset transferred and does not provide information on the nature of the underlying intellectual property or on the nature of the entity's promise. For those reasons, the licence term does not depict when a customer obtains control of the promised licence.
- (b) exclusivity—the 2010 Exposure Draft proposed to distinguish between licences (ie whether they were a performance obligation satisfied over time or at a point in time) on the basis of whether the licence was exclusive. Many respondents to the 2010 Exposure Draft explained that a distinction based on exclusivity was inconsistent with the control principle, because exclusivity does not affect the determination of the entity's performance. In addition, respondents stated that a distinction based on exclusivity would not be operational, because it would require the boards to provide more clarity on how the term 'exclusive' would be interpreted. The boards observed that exclusivity is another restriction that represents an attribute of the asset transferred, rather than the nature of the underlying intellectual property or the entity's promise in granting a licence.
- (c) consumption of the underlying intellectual property—the boards also considered but rejected an approach that would differentiate between licences on the basis of the amount of the underlying intellectual property that was used up, or consumed by, a licence. This is because the intellectual property can be divided in many ways such as by time, geographical region or other restriction on use, and the rights can be provided to more than one customer at the same time through different licences. Consequently, it would be difficult for an entity to determine how much of the intellectual property was consumed by a particular licence.
- (d) payment terms—the boards decided not to use payment terms to differentiate between licences. This is because payment terms are not indicative of whether the licence provides the customer with a right to access or right to use the intellectual property of the

entity and thus when the performance obligation is satisfied. Instead, payment terms will be agreed by the customer and the entity and will reflect other economic factors such as credit risk and potential cash flows of the asset.

BC413 The boards also considered whether to include a criterion that differentiated the nature of an entity's promise when the promised consideration is dependent on the customer's sales from, or usage of, the licence (often referred to as a sales-based or a usage-based royalty). As a criterion for differentiating licences, this would have resulted in *all* of the promised consideration being recognised over time for such licences, including any fixed amount. The boards decided not to include royalties as a criterion for differentiating licences, because the existence of a sales-based or a usage-based royalty does not solely define performance over time. However, the boards observed that, in some cases, the existence of a sales-based or a usage-based royalty can indicate a 'shared economic interest' between the entity and the customer in the intellectual property being licensed and therefore the customer could reasonably expect that the entity will undertake activities that affect the intellectual property to which the licence relates. The boards also decided, however, to include an exception for the revenue recognition pattern of sales-based or usage-based royalties (see paragraphs BC415–BC421).

When is the performance obligation satisfied?

BC414 The boards observed that when the licence provides the customer with access to the entity's intellectual property, the promised licence represents a performance obligation satisfied over time because the customer will simultaneously receive and benefit from the entity's performance as the performance occurs—that is, the criterion in paragraph 35(a) of IFRS 15 will be met. However, when the licence provides the customer with a right to the entity's intellectual property, the boards decided that the performance obligation will be satisfied at a point in time. In those cases, an entity would need to assess the point in time at which the performance obligation is satisfied (ie when the customer obtains control of the licence) by applying paragraph 38 of IFRS 15. The boards also decided to specify that control of a licence could not transfer before the beginning of the period during which the customer can use and benefit from the licenced property. If the customer cannot use and benefit from the licenced property then, by definition, it does not control the licence. The boards noted that when viewed from the entity's perspective, performance may appear to be complete when a licence has been provided to the customer, even if the customer cannot yet use that licence. However, the boards observed that the definition of control in paragraph 33 of IFRS 15 focuses on the customer's perspective, as explained in paragraph BC121.

Clarifications to IFRS 15 (amendments issued in April 2016)

BC414A The TRG discussed issues relating to the application of the licensing guidance in IFRS 15. The main issues discussed related to:

- (a) determining the nature of the entity's promise in granting a licence of intellectual property;
- (b) the scope and applicability of the sales-based and usage-based royalties exception;
- (c) the effect of contractual restrictions in a licence on identifying the performance obligations in the contract; and
- (d) when the guidance on determining the nature of the entity's promise in granting a licence applies.

BC414B In the light of those discussions and the feedback received, the IASB decided to clarify the application guidance on licensing and the accompanying Illustrative Examples to improve its operability and understandability. In some cases, the IASB concluded that a clarification is not necessary because there is adequate guidance in IFRS 15 with sufficient explanation of the boards' considerations in the Basis for Conclusions. Except for the scope and applicability of the sales-based and usage-based royalties exception, the FASB reached different conclusions about whether and how to address stakeholder concerns.

Determining the nature of the entity's promise in granting a licence of intellectual property

- BC414C IFRS 15 specifies criteria in paragraph B58 for determining whether the nature of the entity's promise in granting a licence is to provide a customer with a right to access the entity's intellectual property as it exists throughout the licence period, or a right to use the entity's intellectual property as it exists at a point in time when the licence is granted. In developing IFRS 15, the boards noted that these criteria were necessary because it is difficult to assess when the customer obtains control of assets in a licence without first identifying the nature of the entity's performance obligation.
- BC414D Paragraph B57 of IFRS 15 (now deleted, see paragraph BC414J) explained that the determination of whether an entity's promise to grant a licence provides a customer with a right to access or a right to use an entity's intellectual property is based on whether the customer can direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted. A customer can direct the use of, and obtain substantially all the benefits from, the intellectual property, if the intellectual property to which the customer has rights is not significantly affected by activities of the entity. In contrast, a customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted if the intellectual property to which the customer has rights changes throughout the licence period. The intellectual property will change when the entity continues to be involved with its intellectual property and undertakes activities that significantly affect the intellectual property to which the customer has rights. Paragraph B58 provides criteria to help an entity assess whether its activities 'change' the intellectual property to which the customer has rights, including whether the expected activities of the entity significantly affect the intellectual property to which the customer has rights.
- BC414E Stakeholders agree that activities that change the form or functionality of the intellectual property would represent activities that affect the intellectual property to which the customer has rights. However, stakeholders have indicated that it was unclear whether the reference in IFRS 15 to changes in the intellectual property solely refers to changes in the form or functionality of the intellectual property, or also includes changes in the value of the intellectual property. This had resulted in different interpretations about how to apply the criteria in paragraph B58(a). Some stakeholders held the view that, for activities to significantly affect the intellectual property to which the customer has rights, those activities must be expected to change the form or functionality of that intellectual property. They thought that changes that solely affect the value of the intellectual property do not significantly affect the intellectual property to which the customer has rights. Others thought that activities that significantly affect the value of the intellectual property are sufficient to conclude that the licence provides a right to access the intellectual property.
- BC414F The IASB decided to clarify the requirements of paragraph B58(a) by providing additional application guidance on when activities change the intellectual property to which the customer has rights in such a way that the ability of the customer to obtain benefit from the intellectual property is significantly affected. The IASB noted that the reference to form or functionality in paragraph B61 (and the Illustrative Examples and the Basis for Conclusions) was not intended to suggest that the nature of a licence is a right to access intellectual property only if the entity's activities significantly affect the form or functionality of the intellectual property to which the customer has rights. Determining the nature of a licence is defined by the criteria in paragraph B58, which do not refer to form or functionality.
- BC414G Paragraph B59A clarifies that the assessment of whether the entity's activities significantly change the intellectual property to which the customer has rights is based on whether those activities affect the intellectual property's ability to provide benefit to the customer. In some cases, the ability of the intellectual property to provide benefit to the customer is derived from the form or functionality of the intellectual property to which the customer has rights and, in other cases, from the value of that intellectual property. If the activities are expected to significantly change the form or functionality of the intellectual property, those activities are considered to significantly affect the customer's ability to obtain benefit from the intellectual property. If the activities do not significantly change the form or functionality, but the ability of the customer to obtain benefit from the intellectual property is substantially derived from, or dependent upon, the entity's activities after the licence is granted, then the activities are also considered to significantly affect the intellectual property (as long as those activities do not result in the transfer of a good or service to the customer). In these cases, it is not necessary for those activities to change the form or functionality of the intellectual property to

significantly affect the ability of the customer to obtain benefit from the intellectual property. For example, in some circumstances (eg many licences of brands), the benefit of the intellectual property is derived from its value and the entity's activities to support or maintain that value.

BC414H The IASB observed that intellectual property that has significant stand-alone functionality derives a substantial portion of its benefit from that functionality. Consequently, if the entity's activities do not significantly change the form or functionality of such intellectual property, then the entity's activities will not significantly affect the customer's ability to derive benefit from that intellectual property. Therefore, the IASB clarified that in these cases the criterion in paragraph B58(a) would not be met and the licence would be a right to use the intellectual property as it existed at the time that it was transferred.

BC414I The IASB has not defined the term 'significant stand-alone functionality' but has made clarifications to the Illustrative Examples to illustrate when the intellectual property to which the customer has rights might have significant stand-alone functionality. In many cases, it will be clear when intellectual property has significant stand-alone functionality. If there is no significant stand-alone functionality, the benefit to the customer might be derived substantially from the value of the intellectual property and the entity's activities to support or maintain that value. The IASB noted, however, that an entity may need to apply judgement to determine whether the intellectual property to which the customer has rights has significant stand-alone functionality.

BC414J The IASB has deleted paragraph B57. This is in response to stakeholder concerns that paragraph B57 has contributed to the confusion about whether the reference to change solely refers to changes in the form or functionality of intellectual property or also includes changes in the value of intellectual property. The IASB is of the view that the addition of paragraph B59A provides clarity about the intended meaning of change in intellectual property, which makes the discussion in paragraph B57 redundant within the context of the application guidance. The discussion in paragraph B57 explained the IASB's logic for the requirements for determining whether an entity's promise to grant a licence provides a customer with either a right to access or a right to use an entity's intellectual property. Accordingly, the IASB has incorporated the content of paragraph B57 into this Basis for Conclusions.

BC414K Having considered the wider implications of amending IFRS 15 before its effective date, the IASB decided to clarify the approach to determining the nature of an entity's promise in providing a licence, rather than change that approach. The IASB is of the view that stakeholder concerns have been addressed adequately by providing greater clarity about how to apply the requirements within the Standard. The IASB acknowledge that, in some cases, the outcome of using its clarified approach may differ from the outcome achieved using the alternative approach contained in the amendments issued by the FASB (see paragraphs BC414L–BC414N).

Alternative approach developed by the FASB

BC414L The FASB developed an alternative approach to determine whether a licence constitutes a right to access or a right to use, based on the nature of the intellectual property. The FASB explained that the basis for this approach is whether an entity's promise to a customer includes supporting or maintaining the intellectual property to which the customer has rights, which in turn largely depends on whether the intellectual property has significant stand-alone functionality.

BC414M The FASB decided that intellectual property is either:

- (a) functional intellectual property, which is intellectual property that has significant stand-alone functionality and derives a substantial portion of its utility (ie its ability to provide benefit or value) from its significant stand-alone functionality. In this case, a customer generally obtains a licence for the right to use intellectual property unless the functionality of the intellectual property is expected to substantively change during the licence period as a result of activities of the entity that do not transfer a good or service to the customer and the customer is contractually or practically required to use the updated intellectual property; or
- (b) symbolic intellectual property, which is intellectual property that does not have significant stand-alone functionality. Substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its

ordinary business activities. In this case, a customer obtains a licence for the right to access intellectual property.

BC414N The FASB's approach looks to the nature of the intellectual property to determine whether the entity's activities significantly affect the intellectual property to which the customer has rights. The FASB's approach has the potential to result in some licences of symbolic intellectual property being classified as a right to access intellectual property, even though there is no expectation that the entity will undertake activities after making the intellectual property available to the customer. For example, the entity may own a brand that it does not support or maintain, but still grants licences to customers to use the brand in television or movie productions that are set in a time period during which the brand was active. Nonetheless, the FASB decided to adopt this alternative approach on the basis of feedback that the approach would be more operable than the approach contained in Topic 606 when it was issued in May 2014, particularly for entities with a significant number of licensing arrangements and those with diversified operations.

Contractual restrictions in a licence and the identification of performance obligations

BC414O Some stakeholders suggested that it was unclear whether particular types of contractual restrictions would affect the identification of the promised goods or services in the contract. For example, an arrangement might grant a customer a licence of a well-known television programme or movie for a period of time (for example, three years), but the customer might be restricted to showing that licensed content only once per year during each of those three years. Those stakeholders acknowledged that paragraph B62 is clear that restrictions of time, geographical region or use do not affect the licensor's determination about whether the licence is satisfied over time or at a point in time. However, in their view, it was unclear whether contractual restrictions affect the entity's identification of its promises in the contract (ie whether the airing restrictions affect whether the entity has granted one licence or three licences). Subsequent to the publication, in July 2015, of the Exposure Draft *Clarifications to IFRS 15*, the TRG discussed some further examples considering whether particular contractual restrictions create separate promises or, instead, merely define attributes of a promise. The TRG also discussed time attributes within the context of applying paragraph B61 of IFRS 15 to renewals of, or extensions to, existing licences (see paragraphs BC414S–BC414U).

BC414P Having considered the wider implications of amending IFRS 15 before its effective date, the IASB decided that no clarification on the identification of performance obligations in a contract containing one or more licences was necessary. This is because, in its view, the clarifications made to IFRS 15 by the amendments issued in April 2016 will assist all entities in applying the requirements for identifying performance obligations contained in paragraphs 22–30 of IFRS 15. Paragraphs BC405–BC406 of IFRS 15 explain that, as is the case with other contracts, contracts that include a promise to grant a licence to a customer require an assessment of the promises in the contract using the criteria for identifying performance obligations (see paragraphs 27–30 of IFRS 15). This assessment is done before applying the criteria to determine the nature of an entity's promise in granting a licence. Consequently, the entity considers all of the contractual terms to determine whether the promised rights result in the transfer to the customer of one or more licences. In making this determination, judgement is needed to distinguish contractual provisions that create promises to transfer rights to use the entity's intellectual property from contractual provisions that establish when, where and how those rights may be used.

BC414Q The IASB considered Example 59 in the Illustrative Examples accompanying IFRS 15. The entity concludes that its only performance obligation is to grant the customer a right to use the music recording. When, where and how the right can be used is defined by the attributes of time (two years), geographical scope (Country A) and permitted use (in commercials). If, instead, the entity had granted the customer rights to use the recording for two different time periods in two geographical locations, for example, years X1–X3 in Country A and years X2–X4 in Country B, the entity would need to use the criteria for identifying performance obligations in paragraphs 27–30 of IFRS 15 to determine whether the contract included one licence covering both countries or separate licences for each country.

BC414R The FASB decided to amend Topic 606 to confirm that the requirements about contractual restrictions of the nature described in paragraph B62 do not replace the requirement for the entity to identify the number of licences promised in the contract. Similarly to the IASB, the FASB also observed that judgement is often required in distinguishing a contract that contains a single licence

with multiple attributes from a contract that contains multiple licences to the customer that represent separate performance obligations.

Renewals of licences of intellectual property

BC414S As noted in paragraph BC414O, the TRG discussed the application of paragraph B61 of IFRS 15 within the context of licence renewals. Paragraph B61 states that ‘... revenue cannot be recognised for a licence that provides a right to use the entity’s intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence’. Some stakeholders asked whether paragraph B61 applies to the renewal of an existing licence or whether the entity could recognise revenue for the renewal when the parties agree to the renewal.

BC414T The discussion at the TRG indicated that this is an area in which judgement is needed. This is because when the entity and the customer enter into a contract to renew (or extend the period of) an existing licence, the entity will evaluate whether the renewal or extension should be treated as a new licence or, alternatively, as a modification of the existing contract. A modification would be accounted for in accordance with the contract modifications requirements in paragraphs 18–21 of IFRS 15. The IASB noted that, although some diversity may arise, IFRS 15 provides a more extensive framework for applying judgement than its predecessor, IAS 18. Again, having considered the wider implications of amending IFRS 15 before its effective date, the IASB decided that a clarification about the application of the contract modification requirements specifically for renewals of licensing arrangements was not necessary.

BC414U The FASB decided to amend Topic 606 and provide an additional example to specify that the entity would generally not recognise revenue relating to the renewal until the beginning of the licence renewal period. Consequently, in some cases, this may result in the recognition of revenue with respect to the renewal or extension at a later date using Topic 606 than using IFRS 15.

When to consider the nature of the entity’s promise in granting a licence

BC414V Paragraph B55 requires an entity to apply the general revenue recognition model (paragraphs 31–38) to determine whether a performance obligation that contains a licence that is not distinct (in accordance with paragraph 27) is satisfied at a point in time or over time. Since IFRS 15 was issued, some stakeholders have asked when the licensing guidance on determining the nature of an entity’s promise applies to a performance obligation that contains a licence and other goods or services. Some held the view that paragraph B55 suggests that an entity would consider the nature of its promise in granting a licence only when the licence is distinct. Others noted that an entity would have to consider the nature of its promise in granting a licence, even when the licence is not distinct, to (a) determine whether a single performance obligation that includes a licence of intellectual property is satisfied over time or at a point in time; and (b) measure progress towards complete satisfaction of that single performance obligation if it is satisfied over time.

BC414W Again, having considered the wider implications of amending IFRS 15 before its effective date, the IASB decided that a clarification in this respect is not necessary. IFRS 15 and the explanatory material in the Basis for Conclusions provide adequate guidance to account for a licence that is combined with another good or service in a single performance obligation. An entity will, however, need to apply judgement to determine the nature of the performance obligation, and to select a method of measuring progress that is consistent with the objective of depicting the entity’s performance.

BC414X In making this judgement, the IASB noted that it did not intend for an entity to disregard the guidance on determining the nature of its promise in granting a licence when applying the general revenue recognition model. In some cases, it might be necessary for an entity to consider the nature of its promise in granting a licence even when the licence is not distinct. The IASB discussed an example in which an entity grants a 10-year licence that is not distinct from a one-year service arrangement. The IASB noted that a distinct licence that provides access to an entity’s intellectual property over a 10-year period could not be considered completely satisfied before the end of the access period. The IASB observed that it would, therefore, be inappropriate to conclude that a single performance obligation that includes that licence is satisfied over the one-year period of the service arrangement. Paragraph BC407 further highlights that an entity considers the nature of its promise in granting the licence if the licence is the primary or dominant component (ie the predominant item) of a single performance obligation.

BC414Y The FASB decided to make amendments that explicitly state that an entity considers the nature of its promise in granting a licence when applying the general revenue recognition model to a single performance obligation that includes a licence and other goods or services (ie when applying the requirements in Topic 606 equivalent to those set out in paragraphs 31–45 of IFRS 15). Consequently, when the licence is not the predominant item of a single performance obligation, this may result in an entity that applies Topic 606 considering the nature of its promise in granting a licence in a greater number of circumstances than an entity applying IFRS 15.

Consideration in the form of sales-based or usage-based royalties⁷

BC415 The boards decided that for a licence of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognise any revenue for the variable amounts until the uncertainty is resolved (ie when a customer's subsequent sales or usage occurs). The boards had proposed a similar requirement in the 2011 Exposure Draft because both users and preparers of financial statements indicated that it would not be useful for an entity to recognise a minimum amount of revenue for those contracts. This is because that approach would inevitably have required the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognised at inception of the contract as a result of changes in circumstances, even though those changes in circumstances are not related to the entity's performance. The boards observed that this would not result in relevant information, particularly in contracts in which the sales-based or usage-based royalty is paid over a long period of time.

BC416 In redeliberating the 2011 Exposure Draft, the boards observed that because the restriction for a sales-based or usage-based royalty on a licence of intellectual property was structured to apply to only a particular type of transaction, other economically similar types of transactions might be accounted for differently. For example, the restriction would not apply to tangible goods that include a significant amount of intellectual property and, instead, any variable consideration to which the entity is entitled in exchange for those tangible goods would be considered under the general requirements for constraining estimates of variable consideration. Some respondents questioned the conceptual rationale for including a restriction that could in some cases result in an outcome that was not consistent with the requirement to recognise some or all of an estimate of variable consideration. Others asked whether they could apply the restriction by analogy if the promised good or service had characteristics similar to a licence of intellectual property and the consideration depended on the customer's future actions. Consequently, the boards considered whether they should do either of the following:

- (a) expand the scope of paragraph B63 of IFRS 15 to constrain all estimates of variable consideration when that consideration depends on the customer's future actions; or
- (b) develop a general principle that could be applied to all contracts that would achieve broadly the same outcomes.

Expand the scope

BC417 The boards considered whether to expand the restriction for a sales-based or usage-based royalty on a licence of intellectual property, whereby revenue recognition would be constrained to zero for any performance obligation when the amount that an entity is entitled to is based on a customer's future actions. However, the boards decided not to introduce this principle into IFRS 15. This is because it would have prevented an entity from recognising any revenue when the goods and services were transferred in cases in which the entity could estimate the variable consideration and meet the objective of constraining estimates of variable consideration.

BC418 The boards also observed that expanding the scope to constrain revenue when consideration is based on the customer's future actions would also have increased complexity. It would have required the boards to create another exception to maintain the requirements for accounting for customer rights of return, which also results in consideration that is dependent on the customer's future actions.

⁷ Clarifications to IFRS 15 issued in April 2016 added paragraphs B63A–B63B of IFRS 15 to clarify when an entity should recognise revenue for a sales-based or usage-based royalty using the requirement in paragraph B63 of IFRS 15. Paragraphs BC415–BC421 should therefore be read together with paragraphs BC421A–BC421J, which explain the boards' considerations in amending the application guidance.

Develop a general principle

- BC419 The boards also considered whether the restriction for a sales-based or usage-based royalty on a licence of intellectual property could be incorporated into a general principle. The boards considered various ways of articulating this principle, including doing so on the basis of the timing of satisfaction of a performance obligation—that is, whether the performance obligation is satisfied over time or at a point in time. Specifically, if the performance obligation to which the variable consideration related was satisfied at a point in time, an entity would include an estimate of variable consideration in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Conversely, if the performance obligation to which the variable consideration related was satisfied over time, an entity could include any estimate in the transaction price (even a minimum amount) provided that the objective of constraining estimates of variable consideration could be met.
- BC420 This approach was based on the rationale that, for a performance obligation satisfied at a point in time, recognition of revenue that could be adjusted up or down would not be a meaningful depiction of the consideration for the related goods or services and, furthermore, any future adjustments to the transaction price (and therefore revenue) would have little correlation with the entity's performance in that period. Conversely, when a performance obligation is satisfied over time, the initial recognition of some but not all of the estimate of variable consideration would be affected by the entity's future performance, so future adjustments to the transaction price would provide useful information because they explain whether the entity's subsequent performance was beneficial (ie the minimum amount is increased) or detrimental (ie the minimum amount is subject to an unexpected reversal). However, the boards rejected this approach because it would have added complexity to the model that would outweigh the benefit.
- BC421 Consequently, the boards decided against applying the restriction for sales-based or usage-based royalties on intellectual property more broadly. Although the boards acknowledge that the requirements in paragraph B63 of IFRS 15 constitute an exception that might not be consistent with the principle of recognising some or all of the estimate of variable consideration, they decided that this disadvantage was outweighed by the simplicity of these requirements, as well as by the relevance of the resulting information for this type of transaction. The boards also noted that because this is a specific requirement intended for only limited circumstances, entities should not apply it by analogy to other types of promised goods or services or other types of variable consideration.

Clarifications to IFRS 15 (amendments issued in April 2016)

- BC421A Paragraph B63 requires an entity to recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property when the later of the following events occurs: (a) the customer's subsequent sales or usage; and (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance in paragraph B63 is referred to as the 'royalties constraint'.
- BC421B Stakeholders had indicated that it was unclear when a sales-based or usage-based royalty is 'promised in exchange for a licence'. Some stakeholders held the view that the royalties constraint applies whenever the royalty relates to a licence of intellectual property, regardless of whether the royalty is also consideration for other goods or services in the contract. Other stakeholders had suggested that the royalties constraint applies only when the royalty relates solely to a licence that is distinct in accordance with paragraph 27 of IFRS 15 or only when the licence is the predominant item to which the royalty relates. Stakeholders had also indicated that it was unclear whether a single sales-based or usage-based royalty should be split into a portion to which the royalties constraint would apply and a portion to which it would not, for example, when the royalty relates to a licence and another good or service that is not a licence.
- BC421C In response to stakeholder concerns, the boards decided to clarify the application of the royalties constraint as follows:
- (a) the royalties constraint applies whenever a licence of intellectual property is the sole or predominant item to which the royalty relates; and

- (b) an entity should not split a single royalty into a portion subject to the royalties constraint and a portion that is subject to the general constraint on variable consideration contained in paragraphs 50–59 of IFRS 15.

Applying the royalties constraint

BC421D The boards decided to clarify in paragraph B63A that the royalties constraint applies to those arrangements for which the licence is the predominant item to which the royalty relates. This is because users of financial statements are likely to view those arrangements as licensing arrangements. The boards had previously observed in paragraph BC415 that it would not be useful for an entity to recognise a minimum amount of revenue for licences of intellectual property for which the consideration is based on the customer's sales or usage. Applying the royalties constraint only when the royalty relates solely to a licence that is distinct in accordance with paragraph 27 of IFRS 15 might unduly restrict its application.

BC421E The boards observed that judgement is required to determine when a licence is the predominant item to which a sales-based or usage-based royalty relates. However, the judgement needed for that determination is likely to be less than the judgement needed to apply the general requirements on variable consideration to those arrangements that would fall outside the scope of the royalties constraint if that scope were to be more restrictive.

BC421F The boards decided against changing the scope of the royalties constraint, including expanding it beyond those situations for which a licence is the predominant item to which a royalty relates. This is because doing so would capture arrangements for which the boards previously concluded that the royalties constraint should not apply (for example, sales of intellectual property or sales of tangible goods that include intellectual property). As noted in paragraphs BC416 and BC421, the royalties constraint is intended to apply only to limited circumstances involving licences of intellectual property and, therefore, entities cannot apply it by analogy to other types of transactions.

BC421G The boards observed that an entity might conclude that a licence is the predominant item to which a sales-based or usage-based royalty relates when there is more than one performance obligation. This conclusion might be reached regardless of whether the entity concludes that the royalty can be allocated entirely to one performance obligation in accordance with the requirements for allocating variable consideration in paragraphs 84–85 of IFRS 15. The boards also observed that the royalties constraint would also apply when the royalty predominantly relates to two or more licences promised in a contract, rather than a single licence.

BC421H The boards made consistent clarifying amendments to the Illustrative Examples to more clearly support the conclusions reached about when a sales-based royalty would be recognised. However, the boards decided not to amend paragraph B63 or provide further Illustrative Examples for more complex fact patterns.

BC421I In reaching this decision, the IASB considered a similar example to Example 60 accompanying IFRS 15 and concluded that when a time-based measure of progress appropriately depicts an entity's performance under the licence, recognising the sales-based royalty as and when the customer's sales occur would generally be appropriate. This is because, as noted in paragraph BC219, the objective of the royalties constraint is to prevent an entity from recognising revenue for uncertain amounts until the uncertainty is resolved (ie when the customer's subsequent sales or usage occurs). In effect, the requirement in paragraph B63 constrains the amount of revenue that can be recognised when or as a performance obligation is satisfied, rather than constraining the total amount of the transaction price to be allocated. Paragraph B63(b) reflects one of the key principles of IFRS 15, which is to recognise revenue only when (or as) an entity satisfies a performance obligation. If the entity has satisfied (or partially satisfied) the performance obligation to which the royalty relates, paragraph B63(a) further constrains the recognition of revenue until the uncertainty about the amount of revenue is resolved. Consequently, an entity recognises revenue from a sales-based or usage-based royalty when (or as) the customer's subsequent sales or usage occur, unless recognition in that manner would accelerate the recognition of revenue for the performance obligation to which the royalty solely or partially relates ahead of the entity's performance towards complete satisfaction of the performance obligation based on an appropriate measure of progress.

Splitting a royalty

- BC421J Paragraph B63B of IFRS 15 clarifies that an entity should recognise revenue from a sales-based or usage-based royalty wholly in accordance with either the requirement in paragraph B63 (if paragraph B63 applies) or the requirements on variable consideration contained in paragraphs 50–59 of IFRS 15 (if paragraph B63 does not apply). The boards made this clarification in paragraph B63B because the boards concluded that (a) it would be more complex to account for part of a royalty under the royalties constraint and another part under the general requirements for variable consideration; and (b) doing so would not provide any additional useful information to users of financial statements. This is because splitting a royalty would result in an entity recognising an amount at contract inception that would reflect neither the amount to which the entity expects to be entitled based on its performance, nor the amount to which the entity has become legally entitled during the period.

Repurchase agreements (paragraphs B64–B76)

- BC422 When developing the requirements for control, the boards considered how an entity should apply the requirements to contracts in which the entity sells an asset and also enters into a repurchase agreement (either in the same contract or in another contract).
- BC423 The boards observed that repurchase agreements generally come in three forms—forwards, call options and put options. However, the boards decided that an arrangement in which an entity subsequently decides to repurchase a good after transferring control of that good to a customer would not constitute a repurchase agreement as described in paragraph B64 of IFRS 15. This is because the entity's subsequent decision to repurchase a good without reference to any pre-existing contractual right does not affect the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the good upon initial transfer. In other words, the customer is not obliged to resell that good to the entity as a result of the initial contract. The boards observed that in those cases, the entity should, however, consider whether the customer obtained control of the good initially and may need to consider the requirements for principal versus agent in paragraphs B34–B38 of IFRS 15.

A forward or a call option

- BC424 If an entity has an obligation or a right to repurchase an asset (ie a forward or a call option, respectively), the boards decided that the customer does not obtain control of the asset and, therefore, no revenue should be recognised. This is because the customer is constrained in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Because the customer is obliged to return, or to stand ready to return, the asset to the entity, the customer cannot use up or consume the entire asset. Moreover, the customer cannot sell the asset to another party (unless that sale is subject to a repurchase agreement, in which case the customer's benefit from the sale is constrained).
- BC425 Theoretically, a customer is not constrained in its ability to direct the use of, and obtain substantially all the benefits from, the asset if an entity agrees to repurchase, at the prevailing market price, an asset from the customer that is substantially the same and is readily available in the marketplace. However, the boards noted that an entity would be unlikely to enter into such a transaction.
- BC426 The boards decided that an entity would account for a forward or a call option as a lease or a financing arrangement, depending on the relationship between the repurchase amount and the original selling price. The FASB also decided to specify that when the forward or call option accounted for as a lease is part of a sale-leaseback transaction, the contract should be accounted for as a financing transaction. Otherwise, the FASB observed that an entity would have been required to account for the transaction as a lease and then as a leaseback, which would not have been appropriate.
- BC427 The boards noted that an entity would not need to consider the likelihood that a call option can be exercised, because the existence of the call option effectively limits the customer's ability to control the asset. However, the boards observed that if the call option is non-substantive, that option should be ignored in assessing whether and when the customer obtains control of a good or service (to be consistent with the general requirement for any non-substantive term in a contract).

A put option

- BC428 The boards decided that if the sale and repurchase agreement resulted in an entity's obligation to repurchase the asset at a customer's request (ie a put option), the customer would obtain control of the asset because the customer is neither obliged to return the asset nor obliged to stand ready to do so. Consequently, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset (ie the customer can sell, use up or consume the entire asset and choose not to exercise the put option). The boards decided that the entity should account for its obligation to stand ready to repurchase the asset, to be consistent with the accounting for the sale of a product with a right of return (see paragraphs BC363–BC367). That results in the entity recognising the following:
- (a) a liability for its obligation to repurchase the asset, measured at the amount of the consideration expected to be paid to the customer;
 - (b) an asset for the entity's right to receive that asset upon settling that liability, measured at an amount that may or may not equal the entity's previous carrying value of the asset; and
 - (c) revenue on transfer of the asset for the difference between the sales price of the asset and the liability recognised for the obligation to repurchase the asset.
- BC429 Some respondents questioned whether that accounting would be appropriate in all cases in which a customer has a put option. For instance, some noted that the contract appears to be economically similar to a lease with a purchase option rather than to a right of return. That might be the case if the entity is required to repurchase the asset at a price that is lower than the original sales price and the surrounding facts and circumstances indicate that the customer will exercise its put option. In those cases, the difference between the original sales price and the repurchase price can be viewed as the amount that the customer pays for a right to use the asset, thereby compensating the entity for the decline in the value of the asset. Some respondents noted that, in other cases, the contract is, in effect, a financing arrangement.
- BC430 The boards agreed with those respondents and decided that if a customer has a right to require an entity to repurchase the asset at a price that is lower than the original sales price and the customer has a significant economic incentive to exercise that right, then the customer does not obtain control of the asset. Although the customer is not obliged to exercise its put option, the fact that it has a significant economic incentive to exercise that right means that it would probably incur a loss if it did not do so. (For example, the repurchase price may be set significantly above the expected market value of the asset at the date of the repurchase. However, the boards observed that an entity should consider factors other than the price when determining that it has a significant economic incentive to exercise its right.) The boards decided that in those cases, the existence of the option effectively restricts the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. For similar reasons, the boards decided that if the customer has the unconditional right to require the entity to repurchase the asset at a price that is greater than the original sales price, and higher than the expected market value of the asset, the customer does not obtain control of the asset.
- BC431 The boards also considered whether other arrangements should be accounted for as a lease, such as when an entity provides its customer with a guaranteed amount to be paid on resale (ie a guaranteed minimum resale value). Accounting for those transactions as leases would be consistent with previous US GAAP, and a number of respondents, primarily from the automotive industry, explained that they viewed the transactions to be economically similar. However, the boards observed that while the cash flows may be similar, the customer's ability to control the asset in each case is different. If the customer has a put option that it has significant economic incentive to exercise, the customer is restricted in its ability to consume, modify or sell the asset. However, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset. Thus, the boards decided that it was not necessary to expand the requirements for repurchase agreements to consider guaranteed amounts of resale.

Accounting for repurchase agreements in which the customer does not obtain control of the asset

- BC432 If an entity enters into a contract with a repurchase agreement and the customer does not obtain control of the asset, the boards decided the following:
- (a) the contract should be accounted for as a lease in accordance with IAS 17 *Leases* or Topic 840 *Leases* if the customer is paying for a right to use the asset; and
 - (b) the contract is a financing arrangement if the net consideration that the entity receives is equal to or less than zero (ie the entity is paying interest).
- BC433 To ensure consistent accounting in IFRS and US GAAP for a financing arrangement that arises from a contract with a customer, the boards decided to provide guidance consistent with Subtopic 470-40 *Debt—Product Financing Arrangements*. Consequently, the FASB decided to amend the guidance in Subtopic 470-40 that discusses arrangements in which an entity sells a product to another entity and, in a related transaction, agrees to repurchase the product. However, the FASB decided not to amend Subtopic 470-40 for transactions in which an entity arranges for another party to purchase products on its behalf and agrees to purchase those products from the other party. In those cases, the entity is required to recognise the products as an asset and to recognise a related liability when the other party purchases the product. The FASB noted that although IFRS 15 results in similar accounting when the other party acts as an agent of the entity (ie the other party does not obtain control of the products), Subtopic 470-40 provides explicit requirements for transactions in which no sale has occurred.

Transition, effective date and early application (paragraphs C1–C9)

Transition (paragraphs C2–C8A)

- BC434 The boards decided that an entity should apply IFRS 15 using either of the following methods:
- (a) retrospectively to each prior reporting period presented in accordance with IAS 8 or Topic 250 *Accounting Changes and Error Corrections*, subject to some optional practical expedients (see paragraphs BC435–BC438); or
 - (b) retrospectively with the cumulative effect of initially applying IFRS 15 recognised as an adjustment to the opening balance of retained earnings at the date of initial application (see paragraphs BC439–BC444).

Retrospective application

- BC435 The 2010 and 2011 Exposure Drafts proposed that an entity should apply the requirements retrospectively in accordance with IAS 8 or Topic 250. Retrospective application ensures that all contracts with customers are recognised and measured consistently both in the current period and in the comparative periods presented, regardless of whether those contracts were entered into before or after the requirements became effective. Furthermore, retrospective application provides users of financial statements with useful trend information across the current period and comparative periods. Feedback received from users of financial statements confirmed that retrospective application would be the most useful transition approach for them to be able to understand trends in revenue.
- BC436 In contrast to the feedback received from users of financial statements, many respondents commented that applying the requirements retrospectively would be burdensome, especially for entities with long-term contracts or large and complex multiple-element arrangements. The main concerns raised by those respondents were as follows:
- (a) it may not be possible to obtain historical information for contracts that were completed under previous revenue Standards in IFRS or US GAAP because the relevant information is no longer retained by the entity.

- (b) applying IFRS 15 retrospectively (particularly to completed contracts) may not result in a materially different pattern of revenue recognition, and the significant costs incurred to confirm this fact would not provide much benefit to users of financial statements. For example, for contracts that were considered to be completed (as assessed under previous revenue Standards) several years before the date of initial application, an entity would, theoretically, need to obtain the relevant information to ensure that there was no effect on the pattern of revenue recognition in the financial statements in the year of initial application.
- (c) presenting the effect of IFRS 15 in the comparative years would incur significant preparation and audit costs, because a change in revenue could affect many other line items in the financial statements (such as deferred tax, receivables, interest and foreign currency gains/losses) as well as items that reference an entity's revenue in the financial statements (such as taxes, statutory reporting and financing arrangements).
- (d) the historical information needed to estimate stand-alone selling prices of goods or services in a contract with many performance obligations may not exist.
- (e) entities make assumptions and estimates throughout a contract's life, and it may not be possible to recreate the circumstances that apply historically without the use of hindsight.

Retrospective application with practical expedients (paragraphs C4–C6)

- BC437 The boards decided that although retrospective application would generally impose increased preparation costs, those costs would be outweighed by the increased benefits to users of financial statements. Consequently, the boards considered how the burden of retrospective application could be eased while, at the same time, retaining the benefits of comparability and consistency that retrospective application would provide. To ease the burden of transition without sacrificing comparability, the boards decided to allow an entity to elect to use one or more of the following practical expedients when applying IFRS 15 retrospectively.

Practical expedient	Rationale
<i>Reducing the number of contracts that require restatement⁸</i>	
For contracts completed before the date of initial application of IFRS 15, an entity need not restate contracts that begin and end within the same annual reporting period.	In considering whether an entity should be required to review and restate all contracts completed before the date of initial application, the boards decided that trend information should be preserved for completed contracts that span annual reporting periods. Consequently, the boards decided to limit the relief to only those contracts that begin and end within the same annual reporting period, because the amount and timing of revenue recognition relating to those contracts would not change between annual reporting periods. The boards noted that this relief would significantly reduce the transition burden on entities that have a large number of short-term contracts. A consequence of this relief is that revenue reported in interim periods before and after the effective date would not necessarily be accounted for on a comparable basis. The boards expect that an entity would not elect to use this relief if it operates in an industry in which comparability across interim reporting periods is particularly important to users of financial statements.
<i>Simplifying how an entity restates contracts with customers⁹</i>	
For contracts completed before the date of initial application of IFRS 15 and that have variable consideration, an entity may use the transaction price at the date that the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.	Full retrospective application of IFRS 15 in accordance with IAS 8 or Topic 250 would require an entity to determine the estimates that it would have made at each of the reporting dates in the comparative periods. The boards considered that making those estimates in the comparative years would increase the complexity and costs of retrospective application. By allowing an entity to use hindsight in estimating variable consideration, the boards decided that transition would be simplified for the following reasons: (a) it would reduce the amount of information that an entity would need to collect throughout the transition period; and (b) the entity would not need to determine the transaction price at the end of each period.

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⁸ *Clarifications to IFRS 15* issued in April 2016 amended paragraph C5 of IFRS 15 to add a further practical expedient to permit an entity not to restate contracts that are completed contracts at the beginning of the earliest period presented. This practical expedient, if applied, would further reduce the number of contracts that require restatement. The IASB's considerations in adding the practical expedient are explained in paragraphs BC445M–BC445N.

⁹ *Clarifications to IFRS 15* issued in April 2016 amended paragraph C5 and added paragraph C7A to add a further practical expedient to simplify how an entity restates contracts with customers that are modified before transition to IFRS 15. The boards' considerations in adding the practical expedient are explained in paragraphs BC445O–BC445R.

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<i>Simplifying retrospective application of other aspects of the requirements</i>	
For all reporting periods presented before the date of initial application of IFRS 15, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue (as specified in paragraph 120 of IFRS 15).	The boards decided that the disclosure of the amount of the transaction price allocated to the remaining performance obligations (as would be required by paragraph 120 of IFRS 15) should not be required for periods presented before the date of initial application of IFRS 15 for the following reasons: (a) the disclosure would be most useful for the current period; and (b) the disclosure could be burdensome to prepare for comparative years, especially when trying to avoid the use of hindsight to estimate the transaction price and the expected timing of satisfaction of those performance obligations.

BC438 As a result of the practical expedients providing some relief from applying IFRS 15 retrospectively, the boards also decided to supplement the transitional disclosure requirements of IAS 8 or Topic 250 to require an entity to provide additional disclosure if it elects to use one or more of the practical expedients. Accordingly, paragraph C6 of IFRS 15 requires an entity to provide an explanation to users of financial statements about which practical expedients were used and, to the extent reasonably possible, a qualitative assessment of the estimated effect of applying those practical expedients.

Retrospective application with the cumulative effect recognised in the current period (paragraphs C7–C8)

BC439 The boards decided to develop an alternative transition method to ease the burden of retrospectively applying IFRS 15 because feedback from preparers and auditors indicated that, although helpful, the practical expedients (see paragraph BC437) would not mitigate much of the implementation challenge of a retrospective transition approach. In contrast, users of financial statements generally supported the requirements for retrospective application with practical expedients because it would provide them with useful information on transition and assist their financial statement analyses.

BC440 As a result of those differing views, transition was one of the topics discussed at four disclosure and transition workshops that were held in late 2012 with both users and preparers of financial statements (see paragraph BC328). During those workshops, users of financial statements acknowledged that another transition method might be appropriate to ease the burden of transition; however, they emphasised their need for trend information, regardless of which method is used.

- BC441 After considering this feedback, the boards decided that as an alternative to retrospective application with practical expedients, an entity could apply IFRS 15 (including the requirements for costs) retrospectively, with the cumulative effect of initially applying IFRS 15 recognised in the current year (referred to as the 'cumulative catch-up' transition method). Specifically, the cumulative effect would be an adjustment to the appropriate opening balance of equity in the year of initial application (ie comparative years would not be restated) for contracts that are not completed at the date of initial application.¹⁰ (The boards clarified that a completed contract is a contract in which the entity has fully performed in accordance with revenue recognition requirements in effect before the date of initial application. Thus, a completed contract would include a contract for which the entity's performance was complete but there was a change in the transaction price after the date of initial application.)¹¹ The boards observed that the cumulative catch-up transition method responds to feedback from auditors and preparers by eliminating the need to restate prior periods and thus reducing costs.
- BC442 The boards noted that applying the cumulative catch-up transition method results in consistent presentation of contracts under previous IFRS or US GAAP during the comparative years and in consistent presentation of any contracts not yet completed at the date of initial application under IFRS 15 in the current year. However, because the comparative information will not be restated under the cumulative catch-up transition method, the boards decided to require additional disclosures to help users of financial statements understand the effect on trend information. Consequently, when an entity uses the cumulative catch-up transition method, it is required to disclose the following information for reporting periods that include the date of initial application:
- (a) the amount by which each financial statement line item is affected in the current year as a result of the entity applying IFRS 15 rather than previous revenue Standards in IFRS; and
 - (b) an explanation of the reasons for the significant changes in those financial statement line items.
- BC443 In other words, to provide the required disclosures, an entity would apply both IFRS 15 and the previous revenue Standards in the year of initial application. Despite requiring an entity to account for revenue transactions in the year of initial application using two different sets of accounting requirements, the boards decided that this method would reduce the overall cost of applying IFRS 15 while still providing information about trends that was requested by users of financial statements.
- BC444 The boards also considered other transition methods as alternatives to the cumulative catch-up method to try to ease the burden of retrospective application. For example, the boards considered requiring a prospective approach that would require entities to apply IFRS 15 only to new contracts or those that are materially modified on or after the date of initial application. However, the boards rejected this approach because prospective application would not result in consistent presentation of existing contracts and new contracts and thus would reduce comparability. In addition, this approach would not provide useful trend information for users of financial statements until existing contracts have been fully satisfied after the date of initial application. Furthermore, the boards observed that this approach would require some entities to incur significant costs of maintaining two accounting systems for contracts that are accounted for in accordance with IFRS 15 and previous revenue Standards in IFRS, until all existing contracts have been completed, which could take many years for entities with long-term contracts.

¹⁰ *Clarifications to IFRS 15* issued in April 2016 amended paragraph C7 of IFRS 15 to permit an entity using the transition method described in paragraph C3(b) to apply IFRS 15 (a) only to contracts that are not completed contracts at the date of initial application (as originally required in paragraph C7 when IFRS 15 was issued); or (b) to all contracts including completed contracts at the date of initial application. The boards' considerations in amending paragraph C7 are explained in paragraphs BC445J–BC445L.

¹¹ The FASB subsequently decided to amend the definition of a completed contract as a contract for which all or substantially all of the revenue was recognised in accordance with the revenue guidance that was in effect before the date of initial application of Topic 606. The IASB's considerations for deciding not to amend the definition, together with an overview of the FASB's considerations for amending the definition, are explained in paragraphs BC445C–BC445I.

Other relief

- BC445 If an entity applies IFRS 15 retrospectively in accordance with paragraph C3(a) of IFRS 15 (ie without electing to use the cumulative catch-up transition method), comparative information *would* be restated. Consequently, the IASB clarified that if an entity applies IFRS 15 retrospectively in accordance with paragraph C3(a), it is not required to provide the current year transition disclosure in paragraph 28(f) of IAS 8.

Clarifications to IFRS 15 (amendments issued in April 2016)

- BC445A The boards discussed requests from some stakeholders for further transition relief in respect of (a) accounting for a completed contract (as defined in paragraph C2(b)) on transition to IFRS 15; and (b) accounting for modifications to a contract that occurred before transition to IFRS 15. The IASB decided (a) to expand the application of the transition method described in paragraph C3(b) by allowing an entity a choice to apply IFRS 15 to all contracts including completed contracts; and (b) to provide transition relief for contract modifications. The FASB decided to make similar amendments to Topic 606. The IASB additionally decided to allow an entity using the transition method described in paragraph C3(a) not to restate completed contracts at the beginning of the earliest period presented. The following paragraphs explain the boards' considerations in providing the additional practical expedients.

Completed contracts

- BC445B The boards considered the following questions about the transition requirements in IFRS 15 with respect to a completed contract:

- (a) definition of and accounting for a completed contract.
- (b) providing an entity applying paragraph C3(b) of IFRS 15 with the choice of applying IFRS 15 to all contracts including completed contracts at the date of initial application.
- (c) permitting an entity applying paragraph C3(a) of IFRS 15 not to restate completed contracts at the beginning of the earliest period presented.

Definition of and accounting for a completed contract

- BC445C Some stakeholders, mainly in the US, highlighted potential difficulties with respect to the definition of a completed contract in paragraph C2(b) and the accounting for a completed contract once IFRS 15 becomes effective. They were unclear whether the boards intended that any previously unrecognised revenue from a completed contract that is not transitioned to IFRS 15 would continue to be accounted for in accordance with the previous revenue Standards. In addition, referring to the words 'transferred all of the goods or services' in the definition of a completed contract, they commented that:

- (a) *transfer* of goods or services is a notion that is introduced in IFRS 15 and does not exist in previous revenue Standards.
- (b) it is unclear how an entity would continue to account for a completed contract in accordance with the previous revenue Standards, which would be withdrawn once IFRS 15 becomes effective.
- (c) the boards' considerations explained in paragraph BC444 for rejecting a prospective transition method do not support the use of the previous revenue Standards once IFRS 15 becomes effective. As explained in paragraph BC444, one of the reasons for rejecting prospective transition methods was the 'significant costs of maintaining two accounting systems...until all existing contracts have been completed, which could take many years for entities with long-term contracts'.

- BC445D The IASB concluded that it was not necessary to change the definition of a completed contract to address the issues raised. In relation to the words 'transferred all of the goods or services' in the definition of a completed contract, the IASB noted that it did not intend that an entity would apply the 'transfer of control' notion in IFRS 15 to goods or services identified in accordance with previous revenue Standards. The IASB noted that paragraph BC441 refers to performance in accordance with previous revenue Standards. Consequently, in many situations the term 'transferred' would mean 'delivered' within the context of contracts for the sale of goods and 'performed' within the context of contracts for rendering services and construction contracts. In some situations, the entity would use judgement when determining whether it has transferred goods or services to the customer. For example, an entity may need to use judgement to determine when it has transferred rights to use its assets (for example, rights granted within a licence agreement), because there is no specific guidance on the transfer or delivery of such rights in IAS 18.
- BC445E The IASB observed that if an entity chooses not to apply IFRS 15 to completed contracts in accordance with paragraph C5(a)(ii) or the amended paragraph C7, only contracts that are not completed contracts are included in the transition to IFRS 15. The entity would continue to account for the completed contracts in accordance with its accounting policies based on the previous revenue Standards. The IASB's decision, when it issued IFRS 15 in May 2014, was not to require such an entity to apply IFRS 15 either prospectively or retrospectively to completed contracts.
- BC445F Furthermore, the IASB also observed that its rationale for rejecting a prospective transition method because of the costs of maintaining two systems is less relevant to completed contracts for two reasons. First, the IASB expects the volume of completed contracts with unrecognised revenue at the date of transition to IFRS 15 to be significantly less than the volume of all ongoing contracts that would be included in the transition to IFRS 15. Second, for many completed contracts, the IASB does not expect the accounting under previous revenue Standards to continue for many years after transition, because the goods or services have been transferred before the transition to IFRS 15.
- BC445G Some stakeholders expressed a view that accounting for completed contracts using the previous revenue Standards after IFRS 15 becomes effective would not provide useful financial information to users of financial statements. When developing the transition method described in paragraph C3(b), the boards considered feedback from users of financial statements and decided to require an entity to provide additional disclosures to help users understand the effect of that transition method on trend information (see paragraphs BC442–BC443). The IASB observed that as part of the disclosures required by paragraph C8 an entity could provide additional information about the amount of revenue recognised using previous revenue Standards, if the entity concludes that such information would be helpful to users. In addition, when selecting a transition method, the IASB expects that an entity would consider whether the selected transition method provides useful information to users of its financial statements. If the entity were to conclude that excluding completed contracts from the transition to IFRS 15 would not provide useful information to users, and if that is an important consideration for the entity, then the entity could decide to include completed contracts in its transition to IFRS 15.
- BC445H The FASB decided to amend Topic 606 to define a completed contract as a contract for which all (or substantially all) of the revenue was recognised in accordance with the previous revenue Standards. The FASB believes that the objective of the transition guidance in Topic 606 should be to ensure that all (or substantially all) of the revenue from contracts with customers that is recognised after transition to Topic 606 should be recognised in accordance with Topic 606. Accordingly, the FASB decided to amend the definition of a completed contract so that an entity would apply Topic 606 to all contracts for which all (or substantially all) of the revenue was not recognised under the previous revenue Standards. The FASB acknowledged that an entity would need to apply judgement in some cases to determine whether a contract is completed.
- BC445I The IASB observed that the boards' different decisions regarding amendments to the definition of a completed contract give rise to a difference between IFRS 15 and Topic 606. However, the IASB noted that an entity could avoid the consequences of the different definitions by choosing to apply IFRS 15 retrospectively to all contracts including completed contracts (see paragraph BC445K).

Providing an entity applying IFRS 15 in accordance with paragraph C3(b) with the choice of applying IFRS 15 to all contracts including completed contracts at the date of initial application

BC445J The boards decided to amend paragraph C7 to provide an entity with a choice of applying IFRS 15 in accordance with paragraph C3(b) either (a) only to contracts that are not completed contracts at the date of initial application (which was the original requirement in paragraph C7 when IFRS 15 was issued); or (b) to all contracts including completed contracts at the date of initial application. The boards acknowledged that this choice might result in a decrease in comparability between entities. However, the boards observed that applying the transition method described in paragraph C3(b) to all contracts, including completed contracts, at the date of initial application could result in financial information that is more comparable with financial information provided by entities using the transition method described in paragraph C3(a). Furthermore, the IASB observed that any decrease in comparability between entities because of the choice will be transitory.

BC445K The IASB also observed that:

- (a) an entity that wishes to use the transition method described in paragraph C3(b) and also avoid the consequences of the different definitions of a completed contract in IFRS 15 and Topic 606 could choose to apply IFRS 15 in accordance with paragraph C3(b) to all contracts including contracts that are completed contracts at the date of initial application; and
- (b) some entities will find applying the transition method described in paragraph C3(b) to all contracts less complex operationally than continuing to account for completed contracts under previous revenue Standards and all other contracts under IFRS 15, or using the method described in paragraph C3(a).

BC445L The FASB observed that allowing the choice may help mitigate some of the unanticipated financial reporting consequences that some entities may experience as a result of its amendments to the definition of a completed contract.

Permitting an entity applying IFRS 15 in accordance with paragraph C3(a) not to restate completed contracts at the beginning of the earliest period presented

BC445M The IASB decided to provide an additional practical expedient to permit an entity applying IFRS 15 in accordance with paragraph C3(a) not to restate contracts that are completed contracts at the beginning of the earliest period presented. The IASB noted that reducing the population of contracts to which IFRS 15 applies (the consequence of applying this practical expedient) could reduce the effort and cost of initial application of IFRS 15. In addition, the IASB observed that a similar expedient is currently given to first-time adopters in paragraph D35 of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

BC445N The FASB decided not to provide a similar expedient to the transition guidance because it concluded that application of such an expedient would not faithfully depict a full retrospective application of Topic 606. The IASB acknowledged that the expedient could affect the comparability of financial information under the full retrospective method, but concluded that this would be outweighed by the benefit provided by the reduced transition costs.

Modified contracts

BC445O Some stakeholders highlighted that applying the requirements in paragraphs 20–21 of IFRS 15 to past contract modifications could be complex, especially if the entity has long-term contracts that are modified frequently. To simplify how an entity retrospectively applies IFRS 15 to its contracts with customers, the boards decided to provide an additional practical expedient that would permit an entity to use hindsight when evaluating contract modifications when making the transition to IFRS 15. Consequently, when restating contracts on transition to IFRS 15, an entity could either (a) follow the requirements in paragraphs 20–21; or (b) use the new practical expedient in paragraph C5(c) of IFRS 15. The new practical expedient allows the entity to reflect the aggregate effect of all past contract modifications when identifying the performance obligations, and determining and allocating the transaction price, instead of accounting for the effects of each contract modification separately. The boards observed that the practical expedient would provide some cost relief and

yet would result in financial information that closely aligns with the financial information that would be available under IFRS 15 without the expedient.

BC445P The boards' conclusions on the date at which this practical expedient should be applied are not fully aligned. Both boards decided that an entity applying IFRS 15 in accordance with paragraph C3(a) should apply the practical expedient at the beginning of the earliest period presented. For an entity applying Topic 606 in accordance with paragraph 606-10-65-1(d)(2) (equivalent to paragraph C3(b) of IFRS 15), the FASB decided that the entity should apply the practical expedient at the date of initial application. However, the IASB decided that an entity applying IFRS 15 in accordance with paragraph C3(b) may apply the practical expedient either (a) at the beginning of the earliest period presented; or (b) at the date of initial application.

BC445Q The IASB observed that without the choice of the date at which the practical expedient is applied, entities that apply IFRS 15 in accordance with paragraph C3(b), especially entities with a large number of contracts subject to frequent modifications (for example, some telecommunication companies), might have practical difficulties if they are required to wait until the date of initial application for finalising the cumulative effect of past contract modifications. This is because of the large number of contracts that would have to be evaluated in a relatively short time. Those entities highlighted that the benefit of the practical expedient would be considerably constrained if they cannot finalise the cumulative effect of past contract modifications ahead of the date of initial application of IFRS 15. The IASB observed that this decision creates a difference between IFRS 15 and Topic 606. However, an entity applying IFRS 15 in accordance with paragraph C3(b) could avoid the different reporting outcomes between IFRS 15 and Topic 606 by choosing to apply the practical expedient at the date of initial application.

BC445R The boards considered, but rejected, permitting an entity to account for the unsatisfied performance obligations in a modified contract at transition as if the original contract were terminated and a new contract created as of the transition date. This would be computationally simpler because it eliminates the need to evaluate the effects of modifications before transition to IFRS 15. Under this approach, the amount of consideration allocated to the unsatisfied performance obligations would be the total consideration promised by the customer (including amounts already received) less any amounts already recognised as revenue under previous revenue Standards. Although this might significantly reduce the cost and complexity of applying the transition requirements to contract modifications, the approach was rejected by the boards because it could result in financial information that differed significantly from that under IFRS 15 without the expedient.

Transition to Clarifications to IFRS 15

BC445S The IASB decided to require an entity to apply the amendments to IFRS 15 retrospectively in accordance with IAS 8. In reaching its decision to require retrospective application, the IASB observed that the amendments were intended to clarify the IASB's intentions when developing the requirements in IFRS 15 rather than to change the underlying principles of IFRS 15. The IASB decided not to allow prospective application of the amendments because that would reduce comparability in the limited cases that the amendments may have resulted in significant changes to an entity's application of IFRS 15. This is consistent with feedback received from users of financial statements during the development of IFRS 15 highlighting that retrospective application would be the most useful transition method for them to understand trends in revenue.

BC445T By requiring an entity to apply the amendments as if those amendments had been included in IFRS 15 at the date of initial application, the IASB observed that:

- (a) if the entity applies both IFRS 15 and *Clarifications to IFRS 15* at the same time, any effect of applying the amendments would be reflected in the effects of initially applying IFRS 15.
- (b) if the entity applies *Clarifications to IFRS 15* after the date of initial application of IFRS 15, the effects of initially applying IFRS 15 would be restated for the effects, if any, of initially applying the amendments.

BC445U The outcome of retrospective application of *Clarifications to IFRS 15* will depend on which transition method an entity chooses when it first applies IFRS 15. The choice of the transition method will determine, for example, whether periods before the date of initial application of IFRS 15 are restated as well as the amount and date of the adjustment to retained earnings. Retrospective application of *Clarifications to IFRS 15* will affect only those reporting periods and those contracts to which IFRS 15 is applied. For example, consider an entity that applies IFRS 15 in accordance with paragraph C3(b) on 1 January 2017 and *Clarifications to IFRS 15* on 1 January 2018. Retrospective application of *Clarifications to IFRS 15* would not require the restatement of financial information before 1 January 2017 for the effects of the amendments. Any effect of applying the amendments would be included in a restated cumulative effect adjustment as of 1 January 2017.

Effective date and early application (paragraphs C1–C1B)

Effective date¹²

BC446 In the 2011 Exposure Draft, the boards indicated that the effective date of IFRS 15 would be set to ensure that the start of the earliest comparative period for an entity that is required to present two comparative annual periods (in addition to the current annual period) would be after the final requirements are issued. The boards developed this approach in response to feedback obtained from interested parties through a number of activities, including:

- (a) the IASB's Request for Views on *Effective Dates and Transition Methods* and the FASB's Discussion Paper *Effective Dates and Transition Methods* (October 2010);
- (b) the boards' joint investor outreach questionnaire (April 2011); and
- (c) consultation with systems providers and preparers in 2010 and 2011.

BC447 On the basis of that proposed formula for setting an effective date and of the estimated issue date of IFRS 15 at the time of their decision, the boards would have set the effective date as 1 January 2016. However, many respondents, including respondents in industries for which there could be significant process and system changes required to comply with IFRS 15 (for example, in the telecommunications and software industries), indicated that the proposed formula would not provide them with adequate time. Specifically, those respondents explained that providing only a short time before the earliest comparative period would not be sufficient to ensure that processes and systems were in place to capture the information that would be required to apply IFRS 15 retrospectively. Some respondents further explained that because of the large volume of contracts in their businesses, it would be far more cost-effective to process the information on a real-time basis to ensure that the adjustments to the financial statements were being calculated during the transition period, rather than attempting to retrospectively calculate the adjustments at the date of initial application.

BC448 The boards considered whether their decision to permit an alternative transition method (see paragraphs BC439–BC444) would provide sufficient relief that an effective date of 1 January 2016, would be appropriate. However, the boards noted that if a contract is not completed at the date of initial application, the entity would need to apply IFRS 15 to that entire contract to calculate any cumulative effect that would be recognised in the opening retained earnings in the year of initial application. The boards noted that the industries that would be most affected generally have contracts with durations that would result in those industries still having only a few months to prepare their processes and systems to capture the required information on a real-time basis.

BC449 Consequently, the FASB decided to require that a public entity apply Topic 606 for annual reporting periods beginning after 15 December 2016, and the IASB decided to require that an entity apply IFRS 15 for annual reporting periods beginning on or after 1 January 2017. Although the effective dates are not identical, the boards noted that this difference has

¹² The boards subsequently deferred the effective date of IFRS 15 and Topic 606 by one year. See paragraphs BC453A–BC453H.

resulted from precedents in IFRS and US GAAP. Furthermore, the difference is not significant and the boards did not expect that it would result in a difference in the way that an entity considers the effective date.

- BC450 The boards acknowledged that the period of time from which IFRS 15 is issued until its effective date is longer than usual. However, in this case, the boards decided that a delayed effective date is appropriate because of the unique attributes of IFRS 15, including the wide range of entities that will be affected and the potentially significant effect that a change in revenue recognition has on other financial statement line items.
- BC451 To ensure consistency with the IASB's requirements in IAS 34, the FASB clarified that the first set of interim financial reports in which Topic 606 will apply is the first set of interim financial reports after the effective date (ie 31 March 2017 for a calendar year-end entity). The FASB also decided that this is appropriate because of the relatively long lead time that has been provided to entities.

Early application

- BC452 The FASB decided not to allow entities to apply Topic 606 early, because doing so would have reduced the comparability of financial reporting in the period up to the date of initial application.¹³ Although the IASB agreed that allowing early application would reduce the comparability of financial reporting in the period up to the date of initial application, the IASB noted that IFRS 15 improves accounting for revenue in areas in which there was little guidance under previous revenue Standards in IFRS and, thus, entities should not be precluded from applying IFRS 15 before its effective date. Furthermore, the IASB noted that IFRS 15 should resolve some pressing issues in practice arising from previous revenue recognition requirements. For example, the requirements for determining whether a performance obligation is satisfied over time should address the current diversity in practice associated with the application of the interpretation of IFRS on the construction of real estate.
- BC453 The boards observed that the IASB-only decision to permit early application should not result in differences after the date of initial application in the accounting for revenue between entities applying US GAAP and those applying IFRS that apply IFRS 15 early, even for contracts that straddle the date of initial application.

Deferral of effective date (amendment issued in September 2015)

- BC453A After issuing IFRS 15 and Topic 606, the IASB and the FASB formed a joint Transition Resource Group (TRG) for Revenue Recognition to support the implementation of the Standard. The TRG discussed submissions from stakeholders and its discussions on five topics indicated potential differences of views on how to implement the requirements in IFRS 15. Consequently, those topics were discussed by the boards and each board decided to propose targeted amendments to IFRS 15 and Topic 606. The IASB published an Exposure Draft *Clarifications to IFRS 15* in July 2015. In the light of those proposed amendments, the IASB and the FASB each discussed whether to defer the effective date of the Standard.
- BC453B The IASB observed that changing the effective date of a Standard shortly after its issuance creates uncertainty for stakeholders and has the potential to set a bad precedent. The effective date is set after consideration of information obtained in the exposure process about the time needed to implement the requirements. Accordingly, the IASB would consider changing the effective date only in exceptional circumstances. The IASB noted that it had already provided a considerable amount of time between issuing IFRS 15 and the effective date, anticipating that some entities would be required to change information technology systems and processes when applying the Standard. The IASB has also provided substantive relief on transition to IFRS 15 by giving entities a choice of transition methods, one of which does not involve the restatement of comparative financial information. In addition, the IASB

¹³ The FASB subsequently amended Topic 606 to allow all entities to apply the Standard early for annual periods beginning after 15 December 2016. See paragraph BC453H.

observed that the proposed amendments noted in paragraph BC453A are expected to clarify, rather than change, the requirements of the Standard.

BC453C Nonetheless, the IASB decided to propose a deferral of the effective date of IFRS 15 by one year to 1 January 2018 because of the combination of the following factors that result in the circumstances surrounding the implementation of IFRS 15 being exceptional:

- (a) The IASB acknowledged that, although intended to provide clarity, the proposed amendments to IFRS 15 noted in paragraph BC453A may affect some entities that would wish to apply any amendments at the same time as they first apply IFRS 15. Those entities are likely to wish to avoid reporting changes to revenue when first implementing the Standard and then, within a year or two, potentially reporting further changes to revenue as a result of applying any amendments to the Standard. For those entities, a deferral of the effective date by one year would provide additional time to implement any amendments to the Standard.
- (b) IFRS 15 was issued later than had been anticipated when the IASB set the effective date of the Standard, which absorbed some of the implementation time that entities were expecting to have.
- (c) IFRS 15 is a converged Standard with Topic 606—although this was not the only consideration, the IASB observed that there are benefits for a broad range of stakeholders of retaining an effective date that is aligned with the effective date of Topic 606.

BC453D Accordingly, the IASB published the Exposure Draft *Effective Date of IFRS 15* in May 2015 proposing to defer the effective date of IFRS 15 by one year.

BC453E The IASB concluded that a one-year deferral would be sufficient in terms of providing additional time to implement IFRS 15. IASB members observed that the issuance of IFRS 15 in May 2014 had been later than anticipated by some months, not years. Accordingly, a deferral of the effective date of IFRS 15 for anything longer than one year would unnecessarily delay transition by many entities to a new Standard that the IASB views as a substantial improvement to financial reporting.

BC453F Almost all respondents to the Exposure Draft agreed with the proposal to defer the effective date of IFRS 15 for one or more of the reasons noted by the IASB, some noting the exceptional nature of the circumstances surrounding the implementation of IFRS 15. Most also agreed that a one-year deferral should be sufficient and would improve the quality of implementation.

BC453G In the light of the feedback received, the IASB confirmed its decision to defer the effective date of the Standard. The IASB did not change its previous decision to permit early application of IFRS 15.

BC453H For factors similar to those considered by the IASB, the FASB issued an Accounting Standards Update 2015-14 *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date* in August 2015 also deferring the effective date of Topic 606 for all entities by one year. Consequently, a public entity would be required to apply Topic 606 to annual reporting periods beginning after 15 December 2017. The FASB decided to permit early application of Topic 606 by all entities, but not before the original effective date of Topic 606 for a public entity (ie annual reporting periods beginning after 15 December 2016).

Clarifications to IFRS 15 (amendments issued in April 2016)

- BC453I As explained in paragraph BC453C, one of the considerations of the IASB in deferring the effective date of IFRS 15 from 1 January 2017 to 1 January 2018 was that the deferral would provide additional time to entities that wish to implement *Clarifications to IFRS 15* along with IFRS 15. Consequently, the IASB set an effective date for *Clarifications to IFRS 15* that aligns with the revised effective date of IFRS 15.
- BC453J Furthermore, the IASB decided that an entity should be permitted to apply *Clarifications to IFRS 15* earlier than its effective date. This would allow an entity the choice of either:
- (a) applying *Clarifications to IFRS 15* on the same date as it first applies IFRS 15; or
 - (b) applying *Clarifications to IFRS 15* at a date later than when it early applies IFRS 15.
- In other words, an entity that has decided to early apply IFRS 15 would have the flexibility to apply *Clarifications to IFRS 15* either together with the Standard or at a subsequent date.

Analysis of the effects of IFRS 15

- BC454 The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users of financial statements in making economic decisions. To attain that objective, the boards try to ensure that new requirements meet a significant need and that the overall benefits to economic decision-making that would result from improved financial reporting justify the costs of providing such information. For example, the boards consider the comparative advantage that preparers have in developing information, compared with the costs that users of financial statements would incur to develop surrogate information. In this evaluation, the boards recognise that the costs of implementing a new standard might not be borne evenly by participants in the financial reporting system. However, both the users of financial statements and the entities that prepare those financial statements benefit from improvements in financial reporting that facilitate the functioning of markets for capital, including credit and the efficient allocation of resources in the economy.
- BC455 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing new requirements and the likely, associated ongoing costs and benefits of each new Standard—these costs and benefits are collectively referred to as ‘effects’. The evaluation of these effects is necessarily subjective and qualitative. This is because quantifying costs and, particularly, benefits, is inherently difficult. Although other standard-setters undertake similar types of analyses, there is a lack of sufficiently well-established and reliable techniques for quantifying this analysis. Consequently, the IASB sees this analysis of the effects as being part of an evolving process. In addition, the assessment undertaken is that of the likely effects of the new requirements because the actual effects would not be known until after the new requirements had been applied. These are subsequently analysed through the Post-implementation Review process.

Overview

- BC456 As explained in paragraphs BC2–BC3, the boards developed IFRS 15 to eliminate the inconsistencies and weaknesses in previous revenue recognition requirements and to improve disclosure requirements related to revenue. However, throughout the project, many preparers and some users of financial statements explained that they did not perceive significant weaknesses in previous revenue recognition requirements. Therefore, those preparers and users questioned whether the benefits of applying a new revenue standard would justify the costs of implementing that standard.
- BC457 To gain insight on the likely effects of IFRS 15, the boards conducted extensive consultation with interested parties through the formal exposure of the proposals and outreach activities. This consultation included three formal exposure documents—a Discussion Paper and two Exposure Drafts—in response to which the boards received and assessed more than 1,500 comment letters. Over the course of the project, the boards and staff also held more than 650 meetings with users of financial statements, preparers, auditors, regulators and other interested parties in a wide range of industries and a number of jurisdictions. Those meetings included general educational sessions about the proposals and in-depth discussions in relation to particular topics. Some meetings also focused on gaining an understanding of the effects of the proposals in specific industries or on

particular transactions. In some cases, the boards undertook additional outreach in those specific industries or on those particular topics for which there were significant operational or other concerns about the effects of the boards' proposals. For example, because of the disparate views of preparers and users of financial statements on the topic of disclosure requirements, the boards sought further feedback in four workshops that brought user and preparer groups together to discuss how to balance the requirements to be more useful for users of financial statements and less burdensome for preparers (see paragraph BC328). In addition, because of the effect of the principles for allocating the transaction price on a typical mobile phone contract, the boards also held a number of meetings with representatives from the telecommunications industry to better understand their concerns and so that those concerns could be considered during redeliberations. The boards' consideration of the feedback received from this industry and their conclusions is included in paragraphs BC287–BC293 and BC473–BC476.

- BC458 The boards considered in their redeliberations all of the feedback received and, as a result, decided to modify or clarify many aspects of the revenue recognition model to reduce the burden of implementing and applying the proposed requirements. Discussion of this feedback and the resulting changes in different aspects of the model are included throughout the Basis for Conclusions and are summarised in this analysis of the effects.
- BC459 Overall, the boards concluded that the improvements to financial reporting would justify the costs of implementing IFRS 15. In making this assessment, the boards considered:
- (a) how revenue from contracts with customers would be reported in the financial statements;
 - (b) how the comparability of financial information would be improved and the benefit of better economic decision-making as a result of improved financial reporting;
 - (c) the likely compliance costs for preparers of financial statements; and
 - (d) the likely costs of analysis for users of financial statements.

Reporting revenue from contracts with customers in the financial statements

- BC460 IFRS 15 replaces the previous limited revenue recognition requirements in IFRS and the broad revenue recognition concepts and industry-specific requirements in US GAAP with a robust and comprehensive framework that is applied to all revenue contracts with customers (except for lease, insurance and financial instruments contracts which fall within the scope of other Standards). This framework provides a basis that should be more easily applied to complex transactions and that provides timely guidance for evolving revenue transactions.
- BC461 The framework in IFRS 15 also fills a gap by providing requirements for revenue transactions that had not previously been addressed comprehensively, such as transactions for revenue for the provision of services and for revenue resulting from licences of intellectual property. In addition, IFRS 15 provides requirements for issues such as contract modifications that were previously addressed only for a particular industry. IFRS 15 also provides improved requirements for some transactions such as multiple-element arrangements (see paragraphs BC470–BC472).
- BC462 By providing a comprehensive framework, one of the most significant effects of IFRS 15 in reporting revenue from contracts with customers is greater consistency in the accounting for economically similar transactions. This is because the diversity in practice that developed as a result of weaknesses in previous revenue recognition requirements in IFRS and US GAAP would be eliminated. However, the previous inconsistencies in the accounting and the diversity in practice that existed before the issuance of IFRS 15 may mean that the nature and extent of the changes would likely vary between entities and industries. For example, some industries, such as the telecommunications and software industries, may have significant changes. This is because those industries had narrow and transaction-specific industry revenue recognition requirements in US GAAP (which were often referred to by entities applying IFRS). However, other industries, such as the construction industry, may see minimal changes overall but significant changes for particular entities or jurisdictions that may have interpreted previous requirements differently to apply to their specific transactions. For other contracts, such as straightforward retail transactions, IFRS 15

would have little, if any, effect. The boards were aware of those varying effects when developing IFRS 15 and took them into account in their decision-making. In many cases, the boards observed that the requirements in IFRS 15 may be broadly consistent with previous revenue recognition requirements or practices, thus limiting the effects of IFRS 15 for many entities.

BC463 In making their assessment of the nature of the changes in the reporting of revenue from contracts with customers (ie the recognition and measurement of revenue), the boards observed that the following parts of the revenue recognition model are expected to result in the most significant changes for some entities:

- (a) transfer of control: basis for the timing of revenue recognition;
- (b) identification of performance obligations in a contract;
- (c) allocating the transaction price to performance obligations based on relative stand-alone selling prices; and
- (d) measurement of revenue.

Transfer of control: basis for the timing of revenue recognition

BC464 Previous revenue recognition requirements typically determined the timing of revenue recognition depending on whether the asset transferred was a good or a service. Both IFRS and US GAAP required revenue to be recognised for goods when risks and rewards transferred and, for services, as the service was performed. However, both approaches presented challenges in determining when to recognise revenue and often resulted in accounting for economically similar transactions differently. For example, when determining when to recognise revenue for the transfer of a good, it was often difficult for an entity to judge whether a preponderance (or some other balance) of the risks and rewards had been transferred to the customer. In some contracts, there could be significant difficulty in interpreting whether the asset to be transferred was a good or a service, therefore, making it difficult to rationalise why for one asset, revenue should be recognised only when the asset was complete (ie a good), whereas for another asset, revenue should be recognised continuously as that asset is created (ie a service). Some of this difficulty was due to the vague and narrow definition of services in US GAAP and the lack of clear rationale (ie a Basis for Conclusions) in IFRS for why, in some cases, revenue should be recognised for a service over time. In some cases, entities that applied IFRS consulted the rationale in US GAAP for why revenue would be recognised over time for a service. That rationale explained that this was because the entity was transferring a service continuously. However, that rationale did not address many specific application questions in IFRS about determining whether specific items met the definition of a service. In response, the IASB developed an Interpretation to help clarify whether the construction of real estate would be accounted for as a good or a service (ie a performance obligation satisfied at a point in time or over time). However, many observed that the principle in that Interpretation was difficult to understand and apply.

BC465 In the light of the challenges with previous revenue recognition requirements, the boards observed that applying the single framework in IFRS 15 to determine the timing of revenue recognition for both goods *and* services would improve the consistency in accounting for revenue. This is because the framework would be applied to the attributes of the goods and services transferred, together with the terms of the contract, rather than only to the type of contract. In addition, the boards determined that the core principle in IFRS 15, based on the notion of transferring control, would further improve the consistency of reporting because it would provide a more objective assessment for determining the timing of revenue recognition.

BC466 The boards noted that the application of the core principle may not result in changes for all contracts. For example, the boards acknowledge that for construction contracts, the application of the criteria for when a good or service transfers over time (and thus, is a performance obligation satisfied over time) in IFRS 15 would likely broadly result in the same accounting as required by previous revenue recognition requirements for contracts that met the definition of 'services'. However, the boards observed that the application of IFRS 15 could result in changes for those contracts for which, under previous revenue recognition requirements, it may have been difficult to conclude that the contracted activities were services. This may occur in some manufacturing service contracts and contracts for the construction of residential real estate.

Application guidance: licensing

- BC467 Previous revenue recognition requirements did not determine the timing of revenue recognition for licences based on an assessment of whether the licence was a good or a service. However, those previous requirements were limited and industry-specific. For example, in US GAAP, revenue recognition for licences differed depending on the industry (for example, franchisors, media and entertainment and software) and often was based on features of the licence (for example, licence period or payment terms). Therefore, the previous revenue recognition requirements did not coalesce into a single principle or rule. In IFRS, previous revenue recognition requirements for licences required revenue to be recognised 'in accordance with the substance of the agreement'. However, because those requirements provided minimal guidance on how an entity should assess the 'substance of the agreement', there was significant diversity in practice for the accounting for licences.
- BC468 The boards included in IFRS 15 application guidance on how an entity should assess and account for its licence arrangements. That guidance is anchored in applying key steps of the revenue recognition model—specifically, identifying the performance obligations in a contract and assessing the transfer of control, which the boards operationalised by differentiating between two types of licences. The boards also decided to include in the application guidance the rationale for the guidance and additional illustrative examples to explain the intention, objective and application of those steps and the differentiation between licences.
- BC469 The detailed application guidance for licences in IFRS 15 is intended to help entities determine when a licence is transferred to a customer and thus when revenue can be recognised. Because of the previous diversity in practice in revenue recognition for licences, the addition of the application guidance in IFRS 15 may change practice for some entities. However, the boards observed that the diversity and inconsistencies that previously existed meant that some changes in practice would have occurred regardless of how the boards decided to apply the revenue recognition model to licences.

Identification of performance obligations in a contract

- BC470 The boards cited deficiencies in previous IFRS and US GAAP in the accounting for arrangements with multiple elements as one of the reasons for adding the Revenue Recognition project to its agenda. Although US GAAP was improved after the Revenue Recognition project began, deficiencies still existed. For example, there was no definition of a 'deliverable' in previous US GAAP, even though the term was used to determine the unit of account for revenue transactions. IFRS had even fewer requirements because it only acknowledged that revenue could be recognised for 'separately identifiable components of a single transaction', without providing guidance on how to determine what constituted a 'separately identifiable component'.
- BC471 IFRS 15 addresses those weaknesses by defining promised goods or services that should be accounted for separately as performance obligations. IFRS 15 defines a performance obligation and provides criteria and factors for identifying performance obligations, which are based on the notion of distinct goods or services. These requirements were developed on the basis of extensive consultation and attempts to separate contracts in a meaningful and cost-effective way with intuitive outcomes.
- BC472 The boards observed that the requirements in IFRS 15 for identifying performance obligations may not result in significant changes for many entities. This is because many entities have developed practices to separate contracts with customers in a manner that was similar to the requirements in IFRS 15. However, the boards observed that because there were specific requirements in previous US GAAP, there would be a change in the accounting for incidental obligations and marketing incentives (see paragraphs BC87–BC93). This is because the requirements in IFRS 15 would require an entity to identify and recognise revenue for those goods or services, when previously they may have been recognised as an expense or ignored for the purposes of revenue recognition. The boards observed that two industries that would be particularly affected by this change are the automotive industry (which previously recognised as an expense the promise of maintenance with the purchase of an automobile) and the telecommunications industry (which sometimes did not attribute any revenue to the handsets provided as part of a bundled offering).

Allocating the transaction price to performance obligations based on relative stand-alone selling prices

- BC473 Previous revenue recognition requirements in IFRS and US GAAP for the allocation of consideration in multiple-element arrangements were different. Before IFRS 15, there were no general requirements in IFRS for allocation of consideration (there were some specific requirements in an Interpretation for one type of transaction—that is, customer loyalty points). This was due in part to the lack of guidance on defining an element or unit of account for revenue. In contrast, US GAAP specified that an allocation of the consideration to multiple-elements should be made on a relative selling price basis for some industries. US GAAP also included explicit requirements for some industries on determining the selling price of an item, which required an entity to use vendor-specific objective evidence, but it also permitted the use of estimation techniques in some cases. However, the allocation requirements in the software industry strictly prohibited allocation to individual elements unless the entity obtained vendor-specific objective evidence for all elements of the contract. Because there was often no vendor-specific objective evidence available for one or more undelivered elements, revenue recognition was delayed until all elements had been delivered.
- BC474 Although the principle for allocating the transaction price in IFRS 15 is broadly consistent with previous US GAAP for some industries—that is, allocating the transaction price on a relative stand-alone selling price basis—there may be a change in some outcomes, in particular in the software industry. This is because the boards decided to eliminate the restrictive, industry-specific requirements in US GAAP for allocating consideration in software arrangements (ie the requirement to have vendor-specific objective evidence for all elements in the arrangements before consideration can be allocated). Instead, IFRS 15 requires an entity to estimate the stand-alone selling price of a good or service, if the stand-alone selling price is not directly observable. The boards observed that this change would permit an entity in the software industry to better depict performance by recognising revenue for performance obligations when they are satisfied, instead of when all performance in a contract is complete. In some instances, the boards observed that this may permit entities to eliminate the disclosure of non-GAAP measures that were created because the outcomes from applying previous revenue recognition requirements did not faithfully depict an entity's performance.
- BC475 The boards observed that the requirements for allocating the transaction price in IFRS 15, in conjunction with the requirements for identifying performance obligations, may also result in a significant change in the accounting for bundled arrangements in the automotive and telecommunications industries. As explained in paragraph BC457, the boards' consideration of the feedback received from the telecommunications industry and their conclusions are included in paragraphs BC287–BC293.
- BC476 The boards observed that even though IFRS 15 may result in significant differences in the allocation of the transaction price to performance obligations (and consequently in the amount and timing of the recognition of revenue) in some industries, the change was necessary to provide greater consistency in the recognition of revenue across industries. In addition, the boards observed that the effects were a consequence of the boards' objectives of eliminating industry-specific requirements and defining a common framework that could be applied to all revenue transactions. Furthermore, the boards observed that the allocation requirements in IFRS 15 would result in accounting for a transaction in a manner that more closely reflects the underlying economics.

Measurement of revenue

- BC477 Previous requirements for the measurement of revenue in US GAAP were limited and differed for goods and for services. US GAAP did not provide specific requirements for how to measure revenue for goods, but it nevertheless restricted the amount of revenue that could be recognised for goods to the amount that was fixed or determinable. IFRS required revenue to be recognised for the transfer of goods and services at the fair value of the consideration received/receivable; but, there was no guidance on how to apply that principle because IFRS 13 *Fair Value Measurement* was not effective until 1 January 2013. Consequently, that principle was not consistently applied. In addition, IFRS contained little guidance on how to measure variable consideration. However, both IFRS and US GAAP indicated that the amount of revenue to be recognised for services should be limited to an amount that could be 'estimated reliably'.

- BC478 Thus, IFRS 15 appears to be a significant change from previous revenue recognition requirements because it introduces a customer consideration model and measures revenue using the transaction price, which is defined as the amount to which the entity expects to be entitled in exchange for transferring goods or services. However, previous practices were broadly consistent with this approach and many entities determined the amount of revenue on the basis of the amounts the customer promised to pay. Where IFRS 15 differs from previous revenue recognition requirements is in the additional guidance it provides for estimating consideration when it is variable and in constraining those estimates to ensure revenue is not overstated. In addition, IFRS 15 provides requirements related to other aspects of measuring revenue such as accounting for significant financing components, non-cash consideration and consideration payable to a customer.
- BC479 The additional guidance includes two methods for estimating variable consideration, which may not substantially change the amount of revenue recognised in many industries in which robust estimation methods have been developed over time. However, it may result in changes in the timing of revenue recognised in other cases, for which estimation of variable consideration was either prohibited or not used in the recognition of revenue. For example, in some distribution channels, entities may not have estimated the price of a good or service when that price depended on the eventual sale to an end customer. In those cases, revenue was not recognised until that final sale occurred. The boards concluded that the additional guidance for estimation methods should ensure that performance is better reflected in the financial statements in those cases and should provide greater consistency in estimating variable consideration. The additional guidance would also provide users of financial statements with more transparency on the estimation process, which was often masked with undefined terms such as ‘best estimates’.
- BC480 In addition, the requirements for constraining estimates of variable consideration provide entities with a more specific approach for assessing the likelihood of an entity being entitled to variable consideration and, therefore, whether or not to include an estimate of that variable consideration in the amount of revenue recognised. It would also give users of financial statements more confidence in the amount of revenue recognised in the financial statements by requiring a consistent approach to estimating the amount of variable consideration to which an entity is entitled. The boards included the requirements for constraining estimates of variable consideration in part because of feedback from users of financial statements who demanded that estimates should be of high quality, but also because a significant portion of errors in financial statements have related to the overstatement of revenue.

Improved comparability of financial information and better economic decision-making

- BC481 Before the issuance of IFRS 15, there were significant differences in accounting for economically similar revenue transactions, both within and across industries for entities applying US GAAP. There was also significant diversity in practice in accounting for revenue transactions for entities applying IFRS. Those differences made it difficult for users of financial statements to understand and compare revenue numbers. As explained in paragraphs BC460–BC480, some of this diversity arose because there were limited revenue recognition requirements in IFRS in general and on particular topics. Furthermore, the requirements that were provided were difficult to apply to complex transactions, in part because there was no rationale for those requirements (ie there was no Basis for Conclusions). Those differences also arose because previous revenue recognition requirements in US GAAP were voluminous and often industry-specific or transaction-specific, which also created difficulty for users of financial statements in interpreting the information about revenue. The boards noted that the diversity in practice and challenges to users were often amplified for entities applying IFRS because some preparers selectively referenced US GAAP.
- BC482 Analysis of revenue by users of financial statements was made even more difficult because previous disclosure requirements for revenue were inadequate. Consequently, users of financial statements found it difficult to understand an entity’s revenues, as well as the judgements and estimates made by that entity in recognising those revenues. However, many entities acknowledged a need to provide investors with additional information about revenue and therefore provided this information in other reports outside the financial statements (for example, in earnings releases and shareholder reports).

- BC483 By providing a robust, comprehensive framework that would be applied by entities applying both IFRS and US GAAP, IFRS 15 would eliminate the previous diversity in practice and create greater comparability across entities, industries and reporting periods. In addition, the boards observed that a common revenue Standard should make the financial reporting of revenue comparable between entities that prepare financial statements in accordance with IFRS or US GAAP, resulting in a significant benefit to users. Furthermore, by providing a rationale for the requirements (ie a Basis for Conclusions), the framework should be more easily applied to a broad range of transactions and contracts.
- BC484 In addition, IFRS 15 provides comprehensive disclosure requirements that should greatly improve the information about revenue reported in the financial statements (see paragraphs BC327–BC361). Specifically, the information about revenue would enable users of financial statements to better understand an entity's contracts with customers and revenue from those contracts and to better predict cash flows. This information should also help users of financial statements to make more informed economic decisions. The boards acknowledged that these improvements may increase the costs of the application of IFRS 15 for preparers. However, the boards concluded that these costs were necessary to improve the usefulness of financial reporting in an area that is critical for users of financial statements to the analysis and understanding of an entity's performance and prospects.
- BC485 During outreach, the boards learned that the disclosures required by IFRS 15 may help some entities to eliminate various alternative reporting measures that were created because previous revenue recognition requirements did not adequately depict their performance. Conversely, the boards noted that other industries in which changes may be more significant may be required to create alternative performance measures to help users understand the difference between previous accounting requirements and the requirements under IFRS 15. However, because the requirements adequately depict performance, the boards do not expect that these performance measures would be necessary in the longer term.

Compliance costs for preparers

- BC486 As with any new requirements, there will be costs to implement IFRS 15. The breadth of industries and entities that will be required to apply IFRS 15, and the diversity in practice that existed under previous revenue recognition requirements, make it difficult to generalise the costs to preparers. However, because of the breadth of industries and entities that will be affected, most entities will incur at least some costs. Broadly, the boards expect that a majority of preparers may incur the following costs:
- (a) costs to implement changes in or develop new systems, processes and controls used to gather and archive contract data, make required estimates and provide required disclosures, possibly including fees paid to external consultants;
 - (b) costs to hire additional employees that may be needed to comply with IFRS 15 and modify processes and internal controls accordingly;
 - (c) incremental fees paid to external auditors to audit the financial statements in the period of initial application of IFRS 15;
 - (d) costs required to educate management, finance and other personnel about the effects of IFRS 15; and
 - (e) costs required to educate users of financial statements about the effects on the financial statements.
- BC487 Many of the costs listed in paragraph BC486 will be non-recurring, because they will be incurred only upon initial application of IFRS 15. However, some entities that expect significant changes as a result of applying IFRS 15 expect that the continued application of IFRS 15 will likely cause the following long-term increases in costs:
- (a) increase in audit fees because of the increased volume of disclosures and the difficulty of auditing some of the required estimates (for example, estimates of stand-alone selling price and variable consideration);

- (b) costs to maintain improved systems and make modifications for transactions; and
- (c) higher personnel costs.

BC488 The boards considered those costs in their analysis of the effects for the Standard as a whole and in relation to specific provisions in IFRS 15 when making their decisions. Board members and staff consulted extensively across a wide range of industries and jurisdictions to better understand some of the operational issues arising from the proposals in the Discussion Paper and both Exposure Drafts. The boards took that feedback into consideration in their redeliberations and, as a result, modified or clarified many aspects of the revenue recognition model to reduce the burden of implementing and applying the requirements. Those decisions and their rationale are documented throughout the Basis for Conclusions in relation to specific aspects of the model such as variable consideration and significant financing components. Those clarifications and modifications included:

- (a) clarifying the use of portfolios—the boards clarified that many entities would not need to develop systems to account for each contract individually, especially entities that have a large volume of similar contracts with similar classes of customer. In those cases, the boards noted that entities may apply the requirements to a portfolio of similar contracts.
- (b) practical expedients—the boards added some practical expedients (for example, in the requirements for adjusting the transaction price for significant financing components) to simplify compliance with the requirements in circumstances in which the boards determined that applying the practical expedient would have a limited effect on the amount or timing of revenue recognition.
- (c) disclosure requirements—the boards eliminated the rigidity in the disclosure requirements proposed in the 2011 Exposure Draft that required entities to provide a detailed reconciliation of their contract balances. Instead, the boards decided to require only the opening and closing balances as well as some information on the changes in those balances. The boards also provided similar relief for the reconciliation proposed in the 2011 Exposure Draft for the costs to obtain or fulfil a contract.
- (d) transition requirements—the boards expected that the costs of the systems and operational changes would be incurred primarily during the transition from previous revenue recognition requirements to IFRS 15. Therefore, to ease implementation costs and complexities associated with transition to IFRS 15, the boards decided to provide practical expedients that an entity may elect to use when applying the requirements retrospectively. In addition, the boards introduced an alternative transition method (ie the cumulative catch-up transition method) that would alleviate the costs of transition for many entities because it would not require restatement of prior periods.
- (e) additional illustrations—the boards responded to requests from respondents to provide examples that would illustrate the various aspects of IFRS 15 by providing educational guidance designed to help with implementation and understandability wherever possible. The boards concluded that this would help to reduce both the initial and ongoing cost of compliance, as well as enhancing the consistency of application and therefore comparability of financial statements.

Costs of analysis for users of financial statements

BC489 The boards note that, as with all new requirements, there will be an educational and adjustment period for users of financial statements, during which they may incur costs. Those costs may include costs to modify their processes and analyses. However, the costs are likely to be non-recurring and are likely to be offset by a longer-term reduction in costs from the additional information that would be provided by the improved disclosure requirements. Users of financial statements may also observe a longer-term reduction in education costs, because of the common framework created by IFRS 15, which applies across jurisdictions, industries and transactions.

BC490 In the boards' view, the significant benefits to users of financial statements from IFRS 15 will justify the costs that the users may incur. Those benefits include:

- (a) greater comparability and consistency of reporting revenue from contracts with customers;
- (b) a better depiction of entities' performance; and
- (c) improved understanding of entities' contracts and revenue-generating activities.

Conclusion

BC491 The boards concluded that the issuance of IFRS 15¹⁴ achieves their objectives as outlined in paragraph BC3. This is because IFRS 15 provides a robust and comprehensive framework that:

- (a) will apply to a broad range of transactions and industries and will improve the comparability of the recognition of revenue across industries and jurisdictions;
- (b) can be applied to complex transactions and evolving transactions, resulting in greater consistency in the recognition of revenue; and
- (c) will require enhanced disclosures that will improve the understandability of revenue, which is a critical part of the analysis of an entity's performance and prospects.

BC492 In the light of these achievements, the boards determined that the issuance of IFRS 15 would result in an overall improvement to financial reporting. The boards also concluded that these benefits would be ongoing and would justify the costs of implementing IFRS 15 (for example, systems and operational changes) that would be incurred primarily during the transition from previous revenue recognition requirements.

BC493 However, because of differences in their previous revenue recognition requirements, the boards noted that their rationale for the conclusion that IFRS 15 results in 'an improvement to financial reporting' was slightly different. The differences in their rationale are as follows:

- (a) Previous revenue recognition requirements in US GAAP were rules-based and provided specific requirements for particular transactions and industries. In addition, there were transactions that were not directly in the scope of specific guidance. Consequently, economically similar transactions were often accounted for differently. Overall, the robust and comprehensive framework in Topic 606 should improve comparability in the accounting for economically similar transactions and should result in accounting that better reflects the economics of those transactions.
- (b) As described in paragraph BC460, the previous revenue recognition requirements in IFRS were limited. In particular, IFRS did not include general requirements related to many key issues in revenue recognition such as multiple-element arrangements and how to allocate consideration to those elements. In addition, the lack of a Basis for Conclusions in those previous revenue recognition requirements in IFRS created challenges in assessing how to apply the principles in those requirements. In combination, these factors contributed to diversity in practice across jurisdictions and industries. By providing a comprehensive framework and a Basis for Conclusions, IFRS 15 should be a significant improvement to the previous revenue recognition requirements. Consequently, IFRS 15 should eliminate that previous diversity in practice and thus improve financial reporting.

¹⁴

As indicated in footnote 1, unless indicated otherwise, all references to IFRS 15 in this Basis for Conclusions can be read as also referring to Topic 606 in the FASB's Accounting Standards Codification®.

Consequential amendments

Sales of assets that are not an output of an entity's ordinary activities

- BC494 For the transfer of non-financial assets that are not an output of an entity's ordinary activities, the boards decided to amend their respective Standards to require that an entity apply the requirements from IFRS 15 for the following topics:
- (a) control—to determine when to derecognise the asset.
 - (b) measurement—to determine the amount of the gain or loss to recognise when the asset is derecognised (including any constraints on the transaction price because it is variable).
- BC495 The FASB also decided to apply the requirements from Topic 606 for the existence of a contract to transfer a non-financial asset. Those requirements require an entity to determine whether the parties are committed to perform under the contract, which can be difficult in sales of real estate in which the seller has provided significant financing to the purchaser.
- BC496 Those amendments will result in changes to IAS 16 *Property, Plant and Equipment*, IAS 38 and IAS 40 *Investment Property* and to Topic 360 and Topic 350 *Intangibles—Goodwill and Other*. The changes to those Standards will result in the same accounting requirements under IFRS and US GAAP for the transfer of non-financial assets that are not an output of an entity's ordinary activities. However, because the requirements in those Standards were previously different under IFRS and US GAAP, the boards have different reasons for making those changes.

Consequential amendments to US GAAP

- BC497 A contract for the sale of real estate that is an output of an entity's ordinary activities meets the definition of a contract with a customer and, therefore, is within the scope of Topic 606. Because Subtopic 360-20 *Real Estate Sales* provided requirements for recognising profit on *all* real estate sales, regardless of whether real estate is an output of an entity's ordinary activities, the FASB considered the implications of retaining the requirements in Subtopic 360-20 for contracts that are not within the scope of Topic 606. The FASB noted that retaining those requirements could result in an entity recognising the profit or loss on a real estate sale differently, depending on whether the transaction is a contract with a customer. However, there is economically little difference between the sale of real estate that is an output of the entity's ordinary activities and the sale of real estate that is not. Consequently, the difference in accounting should relate only to the presentation of the profit or loss in the statement of comprehensive income—revenue and expense or gain or loss.
- BC498 Consequently, the FASB decided to amend Topic 360 and create Subtopic 610-20 *Gains and Losses from the Derecognition of Nonfinancial Assets* to require that an entity apply the requirements in Topic 606 for the existence of a contract, for control, and for measurement of a contract for the transfer of real estate (including in-substance real estate) that is not an output of the entity's ordinary activities. If the real estate is a business (and not an in-substance non-financial asset), the requirements in Subtopic 810-10 for consolidation apply.
- BC499 The FASB also decided to specify that an entity apply the requirements in Topic 606 for the existence of a contract, for control and for measurement to contracts for the transfer of all non-financial assets in non-revenue transactions, such as tangible assets within the scope of Topic 360 and intangible assets within the scope of Topic 350. The primary reason for that decision was the lack of clear requirements in US GAAP for accounting for the transfer of non-financial assets when those assets are not an output of an entity's ordinary activities and do not constitute a business or non-profit activity. In addition, the FASB decided, due to the lack of guidance in Topics 350 and 360, to add guidance for how to account for a contract that fails to meet the criteria in paragraph 606-10-25-1.

Consequential amendments to IFRS

- BC500 In IFRS, an entity selling an asset within the scope of IAS 16, IAS 38 or IAS 40 would have applied the recognition principles of the previous revenue Standards in IFRS to determine when to

derecognise the asset and, in determining the gain or loss on the transfer, would have measured the consideration at fair value. However, the IASB noted that there is diversity in practice in the recognition of the gain or loss when the transfer of those assets involves variable consideration, because the previous revenue Standard in IFRS did not provide specific requirements for variable consideration. The IASB decided that requiring application of the requirements in IFRS 15 for control and for measurement (including constraining the amount of variable consideration used in determining the gain or loss) would eliminate the diversity in practice because the requirements in IFRS 15 provide a clear principle for accounting for variable consideration.

BC501 The IASB considered whether it should retain fair value as the measurement basis for transfers of non-financial assets within the scope of IAS 16, IAS 38 and IAS 40. However, the IASB rejected this proposal and, as explained in paragraph BC500, decided to require that an entity apply the measurement requirements in IFRS 15 to transfers of non-financial assets that are not an output of the entity's ordinary activities, for the following reasons:

- (a) measuring the gain on the transfers of non-financial assets that are not an output of the entity's ordinary activities by using the same requirements as for measuring revenue provides users of financial statements with useful information. The IASB decided that it would provide useful information if entities apply the requirements for constraining estimates of variable consideration to any gain that will be recognised on the transfer of the non-financial asset. The IASB acknowledged that in some cases this may result in a loss on the transfer when the transferred asset has a cost basis that is greater than the constrained consideration, which may occur when the asset has a cost basis that is determined using fair value. However, the IASB noted that this outcome is appropriate and useful to users, because of the significant uncertainty about the variable consideration. The IASB also noted that this outcome is consistent with the outcome in a transaction with a customer in which the variable consideration is constrained, but the entity has transferred control of the good or service to the customer.
- (b) it is not necessary to measure the gains on the transfers of non-financial assets to be consistent with other asset disposals, such as disposals of an entity, that are accounted for at fair value in accordance with other Standards (for example, IFRS 10). This is because transfers of non-financial assets that are not an output of an entity's ordinary activities are more like transfers of assets to customers, rather than other asset disposals.
- (c) applying the measurement requirements in IFRS 15 achieves consistency with US GAAP.

A separate project

BC502 The boards also considered whether they should consider the changes to the guidance on transfers of non-financial assets in a separate project. The boards noted that undertaking a separate project would mean that changes to existing Standards would not be made until that project had been completed and became effective. Because of the boards' other standard-setting priorities, and the time required to complete all relevant due process steps for issuing a standard, it might be several years before the existing requirements were replaced. The boards observed that the implications of not proceeding with the proposed consequential amendments would have been as follows:

- (a) for IFRS reporters, the IASB would have needed to amend IAS 16, IAS 38 and IAS 40 to include the revenue recognition criteria from previous revenue Standards in IFRS. This would have resulted in different recognition and measurement requirements for transfers of non-financial assets as compared to contracts with customers.
- (b) for US GAAP reporters, there would have been two sets of recognition and measurement requirements for real estate sales, depending on whether the transfer was with a customer. In addition, no specific requirements would have been provided in US GAAP for transfers of non-financial assets (other than real estate) within the scope of Subtopic 360-10 (for example, equipment) or Topic 350 (for example, intangible assets).

- BC503 Consequently, the boards reaffirmed their decision in the 2011 Exposure Draft that consequential amendments should be made, because this results in consistency in the accounting for the transfers of non-financial assets between IFRS and US GAAP, addresses the lack of requirements for the accounting for transfers of non-financial assets in US GAAP and eliminates possible complexities that might result from retaining separate recognition criteria for transfers of non-financial assets in IFRS.

Transition for first-time adopters of IFRS

- BC504 During redeliberations of the transition requirements, the IASB considered whether to amend IFRS 1 *First-time Adoption of International Financial Reporting Standards* to allow a first-time adopter of IFRS to use the same transition methods for adopting IFRS 15 as specified in paragraph C3 of IFRS 15 as follows:
- (a) retrospectively to each prior period presented in accordance with IAS 8, subject to the practical expedients in paragraph C5 of IFRS 15; and
 - (b) retrospectively with the cumulative effect of initially applying IFRS 15 recognised at the date of initial application (for a first-time adopter of IFRS, this would be the entity's first IFRS reporting period) in accordance with paragraphs C7–C8 of IFRS 15.
- BC505 The IASB decided that the practical expedients in paragraph C5 of IFRS 15 should also apply to a first-time adopter, because both first-time adopters and entities that already apply IFRS would face similar challenges. The IASB observed that IFRS 1 requires that the accounting policies effective at the end of the first IFRS reporting period are applied to all reporting periods from the date of transition to IFRS onwards. This is identical to retrospective application for entities already applying IFRS. Some IASB members also noted that in many jurisdictions that have not yet adopted IFRS, revenue standards are similar to current IFRS. In those jurisdictions, the starting point for transition for a first-time adopter will be similar to entities already applying IFRS.
- BC506 The IASB also clarified that, for any of the practical expedients in paragraph C5 of IFRS 15 that the entity uses, the entity should apply that expedient consistently to all reporting periods presented and disclose which expedients have been used, together with the estimated effect of applying those expedients (see paragraph C6 of IFRS 15).
- BC507 Paragraphs BC439–BC444 explain the boards' rationale for including an additional transition method in IFRS 15. That method requires an entity (that is not a first-time adopter of IFRS) to apply IFRS 15 retrospectively with the cumulative effect of initially applying IFRS 15 recognised in the current year (referred to as the 'cumulative catch-up' transition method). Using the cumulative catch-up transition method, an entity would apply the requirements retrospectively only to contracts that are not completed at the beginning of the date of initial application (which, if applied to a first-time adopter would be the entity's first IFRS reporting period).
- BC508 However, the IASB decided not to amend IFRS 1 to permit first-time adopters of IFRS to use the cumulative catch-up transition method because it is not consistent with the principles of IFRS 1. This is because it would eliminate comparability within a first-time adopter's first IFRS financial statements by providing relief from restating comparative years. The IASB also observed that the cumulative catch-up transition method may not reduce the burden of retrospective application because it would potentially require two separate reconciliations of equity—one for the transition to IFRS, which would be recognised in the earliest comparative period, and one for the transition to IFRS 15, which would be recognised at the beginning of the entity's first IFRS reporting period. This would not only be challenging for preparers, but might also be confusing for users of financial statements.
- BC509 Despite deciding not to amend IFRS 1 to allow first-time adopters to use the cumulative catch-up transition method, the IASB decided to amend IFRS 1 to provide an optional exemption for first-time adopters from the requirements of IFRS 15 in accounting for contracts completed before the earliest period presented. Under this exemption, a first-time adopter would not be required to restate all of its contracts for which it has recognised all of its revenue in accordance with its previous GAAP before the earliest period presented.

Summary of main changes from the 2011 Exposure Draft

BC510 The main changes from the proposals in the 2011 Exposure Draft are as follows:

- (a) IFRS 15 includes additional requirements related to identifying a contract with a customer. Specifically, IFRS 15 includes an additional criterion that must be met before an entity can apply the requirements in IFRS 15 to a contract. This criterion in paragraph 9(e) of IFRS 15 requires an entity to conclude that it is probable that a customer will pay the consideration to which the entity will be entitled by assessing the customer's ability and intention to pay. In addition, IFRS 15 provides guidance for accounting for contracts that do not meet the specified criteria and thus cannot apply IFRS 15.
- (b) IFRS 15 clarifies the objective of the requirements for constraining estimates of variable consideration and provides a level of confidence of 'highly probable' for determining when to include those estimates in the transaction price. This represents a change from the 2011 Exposure Draft, which specified that an entity could only recognise revenue for estimates of variable consideration when an entity was 'reasonably assured' that it would be entitled to that amount.
- (c) IFRS 15 provides additional guidance on the allocation of the transaction price to performance obligations:
 - (i) the residual approach may be used for two or more goods or services with highly variable or uncertain stand-alone selling prices if at least one good or service has a stand-alone selling price that is not highly variable or uncertain; and
 - (ii) allocation of a discount among performance obligations should be done before using the residual approach to estimate the stand-alone selling price for a good or service with a highly variable or uncertain stand-alone selling price.
- (d) IFRS 15 carries forward from the 2011 Exposure Draft the principles related to identifying performance obligations in a contract and determining whether a performance obligation is satisfied over time. However, IFRS 15 clarifies those principles and provides additional guidance for entities in applying those principles.
- (e) IFRS 15 provides additional guidance for determining when a customer obtains control of a licence, by distinguishing between licences that provide a right to access the entity's intellectual property as it exists throughout the licence period and licences that provide a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted. This determination will affect whether the entity satisfies its performance obligation to transfer a licence at a point in time or over time. This represents a change from the 2011 Exposure Draft, which specified that all licences were transferred to the customer at the point in time at which the customer obtained control of the rights. IFRS 15 also clarifies that before determining when the licence transfers to the customer, an entity considers the promises in the contract and applies the requirements for identifying performance obligations.
- (f) IFRS 15 does not include the requirements proposed in the 2011 Exposure Draft to test a performance obligation to determine whether it is onerous.
- (g) IFRS 15 clarifies the disclosures required for revenue from contracts with customers. Specifically, it requires an entity to provide a combination of qualitative and quantitative information about contract balances. The 2011 Exposure Draft required this disclosure to be provided as a reconciliation of contract balances.
- (h) IFRS 15 provides entities with an additional transition method that does not require a restatement of prior periods. The 2011 Exposure Draft proposed only one transition method (ie a retrospective transition method with practical expedients) that requires a restatement of all previous periods presented.

Dissenting Opinion

Dissenting Opinion from *Clarifications to IFRS 15 Revenue from Contracts with Customers* as issued in April 2016

- DO1 Mr Ochi voted against the publication of *Clarifications to IFRS 15 Revenue from Contracts with Customers*. He agrees with all of the clarifying amendments to IFRS 15 and the additional transition reliefs. However, he disagrees with the IASB's decision to require entities to apply *Clarifications to IFRS 15* retrospectively as if those amendments had been included in IFRS 15 at the date of initial application.
- DO2 Referring to the IASB's considerations explained in paragraph BC445T, he thinks that requiring an entity that has applied IFRS 15 before applying these amendments to restate the effects of initially applying IFRS 15 for the effects, if any, of initially applying the amendments is inconsistent with allowing early application of IFRS 15. That entity might be required to restate some contracts twice, first on initially applying IFRS 15 and again on initial application of these amendments. Furthermore, that entity is deprived of the benefit of the new practical expedients added by the IASB.
- DO3 Mr Ochi does not disagree with issuing clarifications, if absolutely necessary, to a Standard before its effective date. However, the IASB's actions in issuing any such clarifying amendments should not be perceived as penalising those entities that begin their implementation process early and rewarding those that delay. Such perceptions could discourage entities from starting the implementation of any new Standard on a timely basis.
- DO4 Mr Ochi noted that the effective date of the new leases Standard has been set so as to provide a long initial implementation period. In that regard, he believes that allowing early application of a Standard supports the smooth application of new Standards.
- DO5 To encourage early application of Standards, he thinks that the IASB should, when deciding the transition requirements for amendments such as *Clarifications to IFRS 15*, give due consideration to those entities that have already early applied the Standard or are in advanced stages of preparing to do so. When deciding the transition requirements, he thinks it is not just a question of considering the extent or potential effect of any clarifications to a Standard; rather it is a matter of principle.

Appendix A

Comparison of IFRS 15 and Topic 606¹⁵

A1 IFRS 15, together with the FASB's Topic 606, issued in May 2014 completes a joint effort by the IASB and the FASB to improve financial reporting by creating a common revenue standard for IFRS and US GAAP that can be applied consistently across various transactions, industries and capital markets. In IFRS 15 and Topic 606, the boards achieved their goal of reaching the same conclusions on all requirements for the accounting for revenue from contracts with customers. However, there are some minor differences in the standards as issued in May 2014, which are as follows:

- (a) **Collectability threshold**—the boards included an explicit collectability threshold as one of the criteria that a contract must meet before an entity can recognise revenue. For a contract to meet that criterion, an entity must conclude that it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In setting the threshold, the boards acknowledged that the term 'probable' has different meanings in IFRS and in US GAAP. However, the boards decided to set the threshold at a level that is consistent with previous revenue recognition practices and requirements in IFRS and in US GAAP. (See paragraphs BC42–BC46.)
- (b) **Interim disclosure requirements**—the boards noted that the general principles in their respective interim reporting requirements (IAS 34 *Interim Financial Reporting* and Topic 270 *Interim Reporting*) would apply to revenue from contracts with customers. However, the IASB decided to also amend IAS 34 to specifically require the disclosure of disaggregated information of revenue from contracts with customers in interim financial reports. The FASB similarly decided to amend Topic 270, to require a public entity to disclose disaggregated revenue information in interim financial reports, but also made amendments to require information about both contract balances and remaining performance obligations to be disclosed on an interim basis. (See paragraphs BC358–BC361.)
- (c) **Early application and effective date**—paragraph C1 of IFRS 15 allows entities to apply the requirements early, whereas Topic 606 prohibits a public entity from applying the requirements earlier than the effective date¹⁶. In addition, the effective date for IFRS 15 is for annual reporting periods beginning on or after 1 January 2017, whereas Topic 606 has an effective date for public entities for annual reporting periods beginning after 15 December 2016¹⁷. (See paragraphs BC452–BC453.)
- (d) **Impairment loss reversal**—paragraph 104 of IFRS 15 requires an entity to reverse impairment losses, which is consistent with the requirements for the impairment of assets within the scope of IAS 36 *Impairment of Assets*. In contrast, consistent with other areas of US GAAP, Topic 606 does not allow an entity to reverse an impairment loss on an asset that is recognised in accordance with the guidance on costs to obtain or fulfil a contract. (See paragraphs BC309–BC311.)
- (e) **Non-public entity requirements**—there are no specific requirements included in IFRS 15 for non-public entities. Entities that do not have public accountability may apply *IFRS for Small and Medium-sized Entities*. Topic 606 applies to non-public entities, although some specific reliefs relating to disclosure, transition and effective date have been included in Topic 606 for non-public entities.

¹⁵ This Appendix reflects the differences between IFRS 15 and Topic 606 when those standards were issued in May 2014 updated to reflect the issue of *Clarifications to IFRS 15* in April 2016.

¹⁶ The FASB subsequently amended Topic 606 in August 2015 to allow all entities to apply the standard early for annual periods beginning after 15 December 2016. See paragraph BC453H.

¹⁷ The IASB issued *Effective Date of IFRS 15* in September 2015 deferring the effective date of IFRS 15 by one year. Similarly, the FASB amended Topic 606 in August 2015 deferring the effective date of Topic 606 by one year. See paragraphs BC453A–BC453H.

A1A As explained in paragraph BC1A, the IASB issued *Clarifications to IFRS 15* in April 2016, which differed in some respects from the amendments to Topic 606 issued by the FASB, and those expected to be issued by the FASB based on its decisions, until March 2016. The differences are as follows:

- (a) **Collectability criterion**—The FASB decided to amend paragraph 606-10-25-1(e) of Topic 606 (equivalent to paragraph 9(e) of IFRS 15), and add implementation guidance and illustrations to clarify that an entity should assess the collectability of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectability of the consideration promised in the contract for all of the promised goods or services. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC46B–BC46E.)
- (b) **Revenue recognition for contracts with customers that do not meet the Step 1 criteria**—The FASB decided to amend paragraph 606-10-25-7 of Topic 606 (equivalent to paragraph 15 of IFRS 15) to add an event in which an entity recognises any consideration received as revenue when (a) the entity has transferred control of the goods or services to which the consideration received relates; (b) the entity has stopped transferring additional goods or services and has no obligation to transfer additional goods or services; and (c) the consideration received from the customer is non-refundable. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC46F–BC46H.)
- (c) **Promised goods or services that are immaterial within the context of the contract**—The FASB decided to amend Topic 606 to state that an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial within the context of the contract with the customer. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC116A–BC116E.)
- (d) **Shipping and handling activities**—The FASB decided to amend Topic 606 to permit an entity, as an accounting policy election, to account for shipping and handling activities that occur after the customer has obtained control of a good as fulfilment activities. The IASB decided not to make a similar amendment to IFRS 15. (See paragraphs BC116R–BC116U.)
- (e) **Presentation of sales taxes**—The FASB decided to amend Topic 606 to provide an accounting policy election that permits an entity to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected from customers (for example, sales taxes, use taxes, value added taxes and some excise taxes). The IASB decided not to provide a similar accounting policy choice in IFRS 15. (See paragraphs BC188A–BC188D.)
- (f) **Non-cash consideration**—The FASB decided to amend Topic 606 to require non-cash consideration to be measured at its fair value at contract inception. The FASB also decided to specify that the constraint on variable consideration applies only to variability in the fair value of the non-cash consideration that arises for reasons other than the form of the consideration. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC254A–BC254H.)

(g) **Licensing**

- (i) **Determining the nature of the entity's promise in granting a licence of intellectual property**—IFRS 15 and Topic 606 require entities to determine whether the nature of an entity's promise in granting a licence is a right to use or a right to access the entity's intellectual property. The IASB did not amend the criteria in IFRS 15 to determine the nature of the licence but clarified that the assessment of whether the entity's activities significantly change the intellectual property to which the customer has rights is based on whether those activities affect the intellectual property's ability to provide benefit to the customer. The FASB decided to amend the criteria to determine the nature of the licence by requiring an entity to classify the intellectual property underlying the licence as functional or symbolic based on whether the intellectual property has significant stand-alone functionality. A licence to functional intellectual property is considered a right to use, while a licence to symbolic intellectual property is considered a right to access the underlying intellectual property. (See paragraphs BC414C–BC414N.)
 - (ii) **Contractual restrictions in a licence and the identification of performance obligations**—The FASB decided to amend Topic 606 to clarify that the requirements about contractual restrictions of the nature described in paragraph B62 do not replace the requirement for the entity to identify the number of licences promised in the contract. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC414O–BC414R.)
 - (iii) **Renewals of licences of intellectual property**—The FASB decided to amend Topic 606 and provide an additional example to specify that the entity would generally not recognise revenue from the transfer of the renewal licence until the beginning of the licence renewal period. The IASB did not make similar amendments. (See paragraphs BC414S–BC414U.)
 - (iv) **When to consider the nature of an entity's promise in granting a licence**—The FASB decided to make amendments that explicitly state that an entity considers the nature of its promise in granting a licence when applying the general revenue recognition model to a single performance obligation that includes a licence and other goods or services. The IASB did not make similar amendments to IFRS 15. (See paragraphs BC414V–BC414Y.)
- (h) **Completed contracts**—The FASB decided to amend the definition of a completed contract to be a contract for which all (or substantially all) of the revenue was recognised in accordance with the previous revenue Standards. The IASB did not make a similar amendment to IFRS 15. (See paragraphs BC445C–BC445I.) Furthermore, the IASB added a practical expedient to allow an entity applying IFRS 15 in accordance with paragraph C3(a) not to restate contracts that are completed contracts at the beginning of the earliest period presented. The FASB decided not to provide the practical expedient. (See paragraphs BC445M–BC445N.)
- (i) **Date of application of the contract modifications practical expedient**—For an entity applying Topic 606 in accordance with paragraph 606-10-65-1(d)(2) (equivalent to paragraph C3(b) of IFRS 15), the FASB decided that the entity should apply the practical expedient at the date of initial application. However, the IASB decided that an entity applying IFRS 15 in accordance with paragraph C3(b) may apply the practical expedient either (a) at the beginning of the earliest period presented; or (b) at the date of initial application. (See paragraphs BC445O–BC445R.)

- A2 IFRS 15 and Topic 606 have been structured to be consistent with the style of other Standards in IFRS and US GAAP (respectively). As a result, the paragraph numbers of IFRS 15 and Topic 606 are not the same. The wording in most of the paragraphs is consistent because IFRS 15 and Topic 606 were issued in May 2014 as a common revenue standard for IFRS and US GAAP. However, the wording in some paragraphs differs because of the different amendments to IFRS 15 and Topic 606 (see paragraph A1A). The following table illustrates how the paragraphs of IFRS 15 and Topic 606, and the related illustrative examples, correspond. Paragraphs in which the wording differs are marked with '*'. The table reflects amendments issued by the FASB, and those expected to be issued by the FASB based on its decisions, until March 2016.

IASB	FASB
MAIN FEATURES	OVERVIEW AND BACKGROUND
N/A	606-10-05-1
IN7	606-10-05-2
IN8	606-10-05-3
	606-10-05-4
IN9	606-10-05-5
N/A	606-10-05-6

OBJECTIVE	
1	606-10-10-1
Meeting the Objective	
2	606-10-10-2
3	606-10-10-3
4	606-10-10-4

REVENUE FROM CONTRACTS WITH CUSTOMERS

SCOPE	
Entities	
N/A	606-10-15-1
Transactions	
5	606-10-15-2
6	606-10-15-3
7	606-10-15-4
8	606-10-15-5

RECOGNITION	
Identifying the Contract	
9	606-10-25-1*
10	606-10-25-2
11	606-10-25-3*
12	606-10-25-4
13	606-10-25-5
14	606-10-25-6
15	606-10-25-7*
16	606-10-25-8
Combination of Contracts	
17	606-10-25-9
Contract Modifications	
18	606-10-25-10
19	606-10-25-11
20	606-10-25-12
21	606-10-25-13
Identifying Performance Obligations	
22	606-10-25-14
23	606-10-25-15
Promises in Contracts with Customers	
24	606-10-25-16*
N/A	606-10-25-16A through 25-16B*
25	606-10-25-17*

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RECOGNITION	
Distinct Goods or Services	
26	606-10-25-18
N/A	606-10-25-18A through 25-18B*
27	606-10-25-19
28	606-10-25-20
29	606-10-25-21
30	606-10-25-22
Satisfaction of Performance Obligations	
31	606-10-25-23
32	606-10-25-24
33	606-10-25-25
34	606-10-25-26
Performance Obligations Satisfied Over Time	
35	606-10-25-27
36	606-10-25-28
37	606-10-25-29
Performance Obligations Satisfied at a Point in Time	
38	606-10-25-30
Measuring Progress towards Complete Satisfaction of a Performance Obligation	
39	606-10-25-31
40	606-10-25-32
<i>Methods for Measuring Progress</i>	
41	606-10-25-33
42	606-10-25-34
43	606-10-25-35
<i>Reasonable Measures of Progress</i>	
44	606-10-25-36
45	606-10-25-37

MEASUREMENT	
46	606-10-32-1
Determining the Transaction Price	
47	606-10-32-2
N/A	606-10-32-2A*
48	606-10-32-3
49	606-10-32-4
Variable Consideration	
50	606-10-32-5
51	606-10-32-6
52	606-10-32-7
53	606-10-32-8
54	606-10-32-9
<i>Refund Liabilities</i>	
55	606-10-32-10
<i>Constraining Estimates of Variable Consideration</i>	
56	606-10-32-11
57	606-10-32-12
58	606-10-32-13
<i>Reassessment of Variable Consideration</i>	
59	606-10-32-14
The Existence of a Significant Financing Component in the Contract	
60	606-10-32-15
61	606-10-32-16
62	606-10-32-17
63	606-10-32-18
64	606-10-32-19
65	606-10-32-20
Non-cash Consideration	
66	606-10-32-21*
67	606-10-32-22
68	606-10-32-23*
69	606-10-32-24

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MEASUREMENT	
Consideration Payable to a Customer	
70	606-10-32-25
71	606-10-32-26
72	606-10-32-27
Allocating the Transaction Price to Performance Obligations	
73	606-10-32-28
74	606-10-32-29
75	606-10-32-30
Allocation Based on Stand-alone Selling Prices	
76	606-10-32-31
77	606-10-32-32
78	606-10-32-33
79	606-10-32-34
80	606-10-32-35
Allocation of a Discount	
81	606-10-32-36
82	606-10-32-37
83	606-10-32-38
Allocation of Variable Consideration	
84	606-10-32-39
85	606-10-32-40
86	606-10-32-41
Changes in the Transaction Price	
87	606-10-32-42
88	606-10-32-43
89	606-10-32-44
90	606-10-32-45

REVENUE FROM CONTRACTS WITH CUSTOMERS

CONTRACT COSTS	
Overview and Background	
N/A	340-40-05-1
N/A	340-40-05-2
Scope and Scope Exceptions	
N/A	340-40-15-1
N/A	340-40-15-2
N/A	340-40-15-3
Incremental Costs of Obtaining a Contract	
91	340-40-25-1
92	340-40-25-2
93	340-40-25-3
94	340-40-25-4
Costs to Fulfil a Contract	
95	340-40-25-5
96	340-40-25-6
97	340-40-25-7
98	340-40-25-8
Amortisation and Impairment	
99	340-40-35-1
100	340-40-35-2
101	340-40-35-3
102	340-40-35-4
103	340-40-35-5
104	340-40-35-6

PRESENTATION	
105	606-10-45-1
106	606-10-45-2
107	606-10-45-3
108	606-10-45-4
109	606-10-45-5

REVENUE FROM CONTRACTS WITH CUSTOMERS

DISCLOSURE	
110	606-10-50-1
111	606-10-50-2
112	606-10-50-3
Contracts with Customers	
113	606-10-50-4
Disaggregation of Revenue	
114	606-10-50-5
115	606-10-50-6
N/A	606-10-50-7
Contract Balances	
116	606-10-50-8
117	606-10-50-9
118	606-10-50-10
N/A	606-10-50-11
Performance Obligations	
119	606-10-50-12
Transaction Price Allocated to the Remaining Performance Obligations	
120	606-10-50-13
121	606-10-50-14
122	606-10-50-15
N/A	606-10-50-16
Significant Judgements in the Application of this Standard	
123	606-10-50-17
Determining the Timing of Satisfaction of Performance Obligations	
124	606-10-50-18
125	606-10-50-19
Determining the Transaction Price and the Amounts Allocated to Performance Obligations	
126	606-10-50-20
N/A	606-10-50-21

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DISCLOSURE	
Assets Recognised from the Costs to Obtain or Fulfil a Contract with a Customer	
N/A	340-40-50-1
127	340-40-50-2
128	340-40-50-3
N/A	340-40-50-4
129	340-40-50-5
N/A	340-40-50-6
Practical Expedients	
129	606-10-50-22
N/A	606-10-50-23

TRANSITION AND EFFECTIVE DATE	
Appendix C	606-10-65-1*

APPLICATION GUIDANCE	
B1	606-10-55-3*
Assessing Collectability	
N/A	606-10-55-3A through 55-3C*
Performance Obligations Satisfied Over Time	
B2	606-10-55-4
Simultaneous Receipt and Consumption of the Benefits of the Entity's Performance	
B3	606-10-55-5
B4	606-10-55-6
Customer Controls the Asset as it is Created or Enhanced	
B5	606-10-55-7
Entity's Performance Does Not Create an Asset with an Alternative Use	
B6	606-10-55-8
B7	606-10-55-9
B8	606-10-55-10

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APPLICATION GUIDANCE	
Right to Payment for Performance Completed to Date	
B9	606-10-55-11
B10	606-10-55-12
B11	606-10-55-13
B12	606-10-55-14
B13	606-10-55-15
Methods for Measuring Progress Towards Complete Satisfaction of a Performance Obligation	
B14	606-10-55-16
Output Methods	
B15	606-10-55-17
B16	606-10-55-18
B17	606-10-55-19
Input Methods	
B18	606-10-55-20
B19	606-10-55-21
Sale with a Right of Return	
B20	606-10-55-22
B21	606-10-55-23
B22	606-10-55-24
B23	606-10-55-25
B24	606-10-55-26
B25	606-10-55-27
B26	606-10-55-28
B27	606-10-55-29

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APPLICATION GUIDANCE	
Warranties	
B28	606-10-55-30
B29	606-10-55-31
B30	606-10-55-32
B31	606-10-55-33
B32	606-10-55-34
B33	606-10-55-35
Principal Versus Agent Considerations	
B34	606-10-55-36
B34A	606-10-55-36A
B35	606-10-55-37
B35A	606-10-55-37A
B35B	606-10-55-37B
B36	606-10-55-38
B37	606-10-55-39
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The amendments contained in this appendix when this Standard was issued in 2014 have been incorporated into the Basis for Conclusions on the relevant Standards.

Illustrative Examples

Hong Kong Financial Reporting Standard 15

Revenue from Contracts with Customers



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Example 60—Access to intellectual property

Example 61—Access to intellectual property

REPURCHASE AGREEMENTS

IE314

Example 62—Repurchase agreements

BILL-AND-HOLD ARRANGEMENTS

IE322

Example 63—Bill-and-hold arrangement

APPENDIX

Amendments to guidance on other Standards

IFRS 15 Revenue from Contracts with Customers Illustrative Examples

These examples accompany, but are not part of, IFRS 15. They illustrate aspects of IFRS 15 but are not intended to provide interpretative guidance.

IE1 These examples portray hypothetical situations illustrating how an entity might apply some of the requirements in IFRS 15 to particular aspects of a contract with a customer on the basis of the limited facts presented. The analysis in each example is not intended to represent the only manner in which the requirements could be applied, nor are the examples intended to apply only to the specific industry illustrated. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IFRS 15.

Identifying the contract

IE2 Examples 1–4 illustrate the requirements in paragraphs 9–16 of IFRS 15 on identifying the contract. In addition, the following requirements are illustrated in these examples:

- (a) the interaction of paragraph 9 of IFRS 15 with paragraphs 47 and 52 of IFRS 15 on estimating variable consideration (Examples 2–3); and
- (b) paragraph B63 of IFRS 15 on consideration in the form of sales-based or usage-based royalties on licences of intellectual property (Example 4).

Example 1—Collectability of the consideration

IE3 An entity, a real estate developer, enters into a contract with a customer for the sale of a building for CU1 million.¹ The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition and the customer has little experience in the restaurant industry.

IE4 The customer pays a non-refundable deposit of CU50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 per cent of the promised consideration. The financing arrangement is provided on a non-recourse basis, which means that if the customer defaults, the entity can repossess the building, but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is CU600,000. The customer obtains control of the building at contract inception.

IE5 In assessing whether the contract meets the criteria in paragraph 9 of IFRS 15, the entity concludes that the criterion in paragraph 9(e) of IFRS 15 is not met because it is not probable that the entity will collect the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

- (a) the customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience);
- (b) the customer lacks other income or assets that could be used to repay the loan; and
- (c) the customer's liability under the loan is limited because the loan is non-recourse.

¹ In these examples monetary amounts are denominated in 'currency units' (CU).

- IE6 Because the criteria in paragraph 9 of IFRS 15 are not met, the entity applies paragraphs 15–16 of IFRS 15 to determine the accounting for the non-refundable deposit of CU50,000. The entity observes that none of the events described in paragraph 15 have occurred—that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 16, the entity accounts for the non-refundable CU50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability, until such time that the entity concludes that the criteria in paragraph 9 are met (ie the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 15 has occurred. The entity continues to assess the contract in accordance with paragraph 14 to determine whether the criteria in paragraph 9 are subsequently met or whether the events in paragraph 15 of IFRS 15 have occurred.

Example 2—Consideration is not the stated price—implicit price concession

- IE7 An entity sells 1,000 units of a prescription drug to a customer for promised consideration of CU1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.
- IE8 When assessing whether the criterion in paragraph 9(e) of IFRS 15 is met, the entity also considers paragraphs 47 and 52(b) of IFRS 15. Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not CU1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to CU400,000.
- IE9 The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty, it is probable that it will collect CU400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 9(e) of IFRS 15 is met based on an estimate of variable consideration of CU400,000. In addition, on the basis of an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 9 of IFRS 15 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the requirements in IFRS 15.

Example 3—Implicit price concession

- IE10 An entity, a hospital, provides medical services to an uninsured patient in the emergency room. The entity has not previously provided medical services to this patient but is required by law to provide medical services to all emergency room patients. Because of the patient's condition upon arrival at the hospital, the entity provides the services immediately and, therefore, before the entity can determine whether the patient is committed to perform its obligations under the contract in exchange for the medical services provided. Consequently, the contract does not meet the criteria in paragraph 9 of IFRS 15 and, in accordance with paragraph 14 of IFRS 15, the entity will continue to assess its conclusion based on updated facts and circumstances.
- IE11 After providing services, the entity obtains additional information about the patient including a review of the services provided, standard rates for such services and the patient's ability and intention to pay the entity for the services provided. During the review, the entity notes its standard rate for the services provided in the emergency room is CU10,000. The entity also reviews the patient's information and to be consistent with its policies designates the patient to a customer class based on the entity's assessment of the patient's ability and intention to pay.

- IE12 Before reassessing whether the criteria in paragraph 9 of IFRS 15 have been met, the entity considers paragraphs 47 and 52(b) of IFRS 15. Although the standard rate for the services is CU10,000 (which may be the amount invoiced to the patient), the entity expects to accept a lower amount of consideration in exchange for the services. Accordingly, the entity concludes that the transaction price is not CU10,000 and, therefore, the promised consideration is variable. The entity reviews its historical cash collections from this customer class and other relevant information about the patient. The entity estimates the variable consideration and determines that it expects to be entitled to CU1,000.
- IE13 In accordance with paragraph 9(e) of IFRS 15, the entity evaluates the patient's ability and intention to pay (ie the credit risk of the patient). On the basis of its collection history from patients in this customer class, the entity concludes it is probable that the entity will collect CU1,000 (which is the estimate of variable consideration). In addition, on the basis of an assessment of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 9 of IFRS 15 are also met. Consequently, the entity accounts for the contract with the patient in accordance with the requirements in IFRS 15.

Example 4—Reassessing the criteria for identifying a contract

- IE14 An entity licences a patent to a customer in exchange for a usage-based royalty. At contract inception, the contract meets all the criteria in paragraph 9 of IFRS 15 and the entity accounts for the contract with the customer in accordance with the requirements in IFRS 15. The entity recognises revenue when the customer's subsequent usage occurs in accordance with paragraph B63 of IFRS 15.
- IE15 Throughout the first year of the contract, the customer provides quarterly reports of usage and pays within the agreed-upon period.
- IE16 During the second year of the contract, the customer continues to use the entity's patent, but the customer's financial condition declines. The customer's current access to credit and available cash on hand are limited. The entity continues to recognise revenue on the basis of the customer's usage throughout the second year. The customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in Quarters 2–4. The entity accounts for any impairment of the existing receivable in accordance with IFRS 9 *Financial Instruments*.
- IE17 During the third year of the contract, the customer continues to use the entity's patent. However, the entity learns that the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates. The entity therefore concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's patent. As a result of this significant change in facts and circumstances, in accordance with paragraph 13 of IFRS 15, the entity reassesses the criteria in paragraph 9 of IFRS 15 and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled. Accordingly, the entity does not recognise any further revenue associated with the customer's future usage of its patent. The entity accounts for any impairment of the existing receivable in accordance with IFRS 9 *Financial Instruments*.

Contract modifications

- IE18 Examples 5–9 illustrate the requirements in paragraphs 18–21 of IFRS 15 on contract modifications. In addition, the following requirements are illustrated in these examples:
- (a) paragraphs 22–30 of IFRS 15 on identifying performance obligations (Examples 7–8);
 - (b) paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration (Examples 6 and 8–9); and
 - (c) paragraphs 87–90 of IFRS 15 on changes in the transaction price (Example 6).

Example 5—Modification of a contract for goods

- IE19 An entity promises to sell 120 products to a customer for CU12,000 (CU100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A—Additional products for a price that reflects the stand-alone selling price

- IE20 When the contract is modified, the price of the contract modification for the additional 30 products is an additional CU2,850 or CU95 per product. The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification and the additional products are distinct (in accordance with paragraph 27 of IFRS 15) from the original products.
- IE21 In accordance with paragraph 20 of IFRS 15, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognises revenue of CU100 per product for the 120 products in the original contract and CU95 per product for the 30 products in the new contract.

Case B—Additional products for a price that does not reflect the stand-alone selling price

- IE22 During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of CU80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of CU15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of CU900 (CU15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is CU1,500 or CU50 per product. That price comprises the agreed-upon price for the additional 30 products of CU2,400, or CU80 per product, less the credit of CU900.
- IE23 At the time of modification, the entity recognises the CU900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of CU80 per product does not reflect the stand-alone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 20 of IFRS 15 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the requirements in paragraph 21(a) of IFRS 15 and accounts for the modification as a termination of the original contract and the creation of a new contract.
- IE24 Consequently, the amount recognised as revenue for each of the remaining products is a blended price of CU93.33 $\{[(CU100 \times 60 \text{ products not yet transferred under the original contract}) + (CU80 \times 30 \text{ products to be transferred under the contract modification})] \div 90 \text{ remaining products}\}$.

Example 6—Change in the transaction price after a contract modification

- IE25 On 1 July 20X0, an entity promises to transfer two distinct products to a customer. Product X transfers to the customer at contract inception and Product Y transfers on 31 March 20X1. The consideration promised by the customer includes fixed consideration of CU1,000 and variable consideration that is estimated to be CU200. The entity includes its estimate of variable consideration in the transaction price because it concludes that it is highly probable that a

significant reversal in cumulative revenue recognised will not occur when the uncertainty is resolved.

- IE26 The transaction price of CU1,200 is allocated equally to the performance obligation for Product X and the performance obligation for Product Y. This is because both products have the same stand-alone selling prices and the variable consideration does not meet the criteria in paragraph 85 that requires allocation of the variable consideration to one but not both of the performance obligations.
- IE27 When Product X transfers to the customer at contract inception, the entity recognises revenue of CU600.
- IE28 On 30 November 20X0, the scope of the contract is modified to include the promise to transfer Product Z (in addition to the undelivered Product Y) to the customer on 30 June 20X1 and the price of the contract is increased by CU300 (fixed consideration), which does not represent the stand-alone selling price of Product Z. The stand-alone selling price of Product Z is the same as the stand-alone selling prices of Products X and Y.
- IE29 The entity accounts for the modification as if it were the termination of the existing contract and the creation of a new contract. This is because the remaining Products Y and Z are distinct from Product X, which had transferred to the customer before the modification, and the promised consideration for the additional Product Z does not represent its stand-alone selling price. Consequently, in accordance with paragraph 21(a) of IFRS 15, the consideration to be allocated to the remaining performance obligations comprises the consideration that had been allocated to the performance obligation for Product Y (which is measured at an allocated transaction price amount of CU600) and the consideration promised in the modification (fixed consideration of CU300). The transaction price for the modified contract is CU900 and that amount is allocated equally to the performance obligation for Product Y and the performance obligation for Product Z (ie CU450 is allocated to each performance obligation).
- IE30 After the modification but before the delivery of Products Y and Z, the entity revises its estimate of the amount of variable consideration to which it expects to be entitled to CU240 (rather than the previous estimate of CU200). The entity concludes that the change in estimate of the variable consideration can be included in the transaction price, because it is highly probable that a significant reversal in cumulative revenue recognised will not occur when the uncertainty is resolved. Even though the modification was accounted for as if it were the termination of the existing contract and the creation of a new contract in accordance with paragraph 21(a) of IFRS 15, the increase in the transaction price of CU40 is attributable to variable consideration promised before the modification. Therefore, in accordance with paragraph 90 of IFRS 15, the change in the transaction price is allocated to the performance obligations for Product X and Product Y on the same basis as at contract inception. Consequently, the entity recognises revenue of CU20 for Product X in the period in which the change in the transaction price occurs. Because Product Y had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product Y is allocated to the remaining performance obligations at the time of the contract modification. This is consistent with the accounting that would have been required by paragraph 21(a) of IFRS 15 if that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.
- IE31 The entity also allocates the CU20 increase in the transaction price for the modified contract equally to the performance obligations for Product Y and Product Z. This is because the products have the same stand-alone selling prices and the variable consideration does not meet the criteria in paragraph 85 that require allocation of the variable consideration to one but not both of the performance obligations. Consequently, the amount of the transaction price allocated to the performance obligations for Product Y and Product Z increases by CU10 to CU460 each.
- IE32 On 31 March 20X1, Product Y is transferred to the customer and the entity recognises revenue of CU460. On 30 June 20X1, Product Z is transferred to the customer and the entity recognises revenue of CU460.

Example 7—Modification of a services contract

- IE33 An entity enters into a three-year contract to clean a customer's offices on a weekly basis. The customer promises to pay CU100,000 per year. The stand-alone selling price of the services at contract inception is CU100,000 per year. The entity recognises revenue of CU100,000 per year during the first two years of providing services. At the end of the second year, the contract is modified and the fee for the third year is reduced to CU80,000. In addition, the customer agrees to extend the contract for three additional years for consideration of CU200,000 payable in three equal annual instalments of CU66,667 at the beginning of years 4, 5 and 6. After the modification, the contract has four years remaining in exchange for total consideration of CU280,000. The stand-alone selling price of the services at the beginning of the third year is CU80,000 per year. The entity's stand-alone selling price at the beginning of the third year, multiplied by the remaining number of years to provide services, is deemed to be an appropriate estimate of the stand-alone selling price of the multi-year contract (ie the stand-alone selling price is 4 years × CU80,000 per year = CU320,000).
- IE34 At contract inception, the entity assesses that each week of cleaning service is distinct in accordance with paragraph 27 of IFRS 15. Notwithstanding that each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation in accordance with paragraph 22(b) of IFRS 15. This is because the weekly cleaning services are a series of distinct services that are substantially the same and have the same pattern of transfer to the customer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).
- IE35 At the date of the modification, the entity assesses the remaining services to be provided and concludes that they are distinct. However, the amount of remaining consideration to be paid (CU280,000) does not reflect the stand-alone selling price of the services to be provided (CU320,000).
- IE36 Consequently, the entity accounts for the modification in accordance with paragraph 21(a) of IFRS 15 as a termination of the original contract and the creation of a new contract with consideration of CU280,000 for four years of cleaning service. The entity recognises revenue of CU70,000 per year (CU280,000 ÷ 4 years) as the services are provided over the remaining four years.

Example 8—Modification resulting in a cumulative catch-up adjustment to revenue

- IE37 An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of CU1 million and a bonus of CU200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 35(b) of IFRS 15 because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

	CU
Transaction price	1,000,000
Expected costs	<u>700,000</u>
Expected profit (30%)	<u>300,000</u>

- IE38 At contract inception, the entity excludes the CU200,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

- IE39 The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress towards complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 per cent of its performance obligation on the basis of costs incurred to date (CU420,000) relative to total expected costs (CU700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 56–58 of IFRS 15. Consequently, the cumulative revenue and costs recognised for the first year are as follows:

	CU
Revenue	600,000
Costs	<u>420,000</u>
Gross profit	<u>180,000</u>

- IE40 In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by CU150,000 and CU120,000, respectively. Total potential consideration after the modification is CU1,350,000 (CU1,150,000 fixed consideration + CU200,000 completion bonus). In addition, the allowable time for achieving the CU200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognised in accordance with paragraph 56 of IFRS 15 and includes the CU200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 27(b) of IFRS 15 and concludes (on the basis of the factors in paragraph 29 of IFRS 15) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.
- IE41 Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 21(b) of IFRS 15). The entity updates its measure of progress and estimates that it has satisfied 51.2 per cent of its performance obligation (CU420,000 actual costs incurred ÷ CU820,000 total expected costs). The entity recognises additional revenue of CU91,200 [(51.2 per cent complete × CU1,350,000 modified transaction price) – CU600,000 revenue recognised to date] at the date of the modification as a cumulative catch-up adjustment.

Example 9—Unapproved change in scope and price

- IE42 An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.
- IE43 The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 18–21 of IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 21(b) of IFRS 15 by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation. The entity considers the constraint on

estimates of variable consideration in paragraphs 56–58 of IFRS 15 when estimating the transaction price.

Identifying performance obligations

- IE44 Examples 10–12 illustrate the requirements in paragraphs 22–30 of IFRS 15 on identifying performance obligations.

Example 10—Goods and services are not distinct

Case A—Significant integration service

- IE45 An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.
- IE46 The promised goods and services are capable of being distinct in accordance with paragraph 27(a) of IFRS 15. That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.
- IE47 However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.
- IE48 Because both criteria in paragraph 27 of IFRS 15 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

Case B—Significant integration service

- IE48A An entity enters into a contract with a customer that will result in the delivery of multiple units of a highly complex, specialised device. The terms of the contract require the entity to establish a manufacturing process in order to produce the contracted units. The specifications are unique to the customer, based on a custom design that is owned by the customer and that were developed under the terms of a separate contract that is not part of the current negotiated exchange. The entity is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials, identifying and managing subcontractors, and performing manufacturing, assembly and testing.
- IE48B The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 27(a) of IFRS 15 because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.
- IE48C The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices

and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraph 27(b) and paragraph 29 of IFRS 15. In this case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities means that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex, specialised devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 27(b) of IFRS 15 is not met, the goods and services that will be provided by the entity are not separately identifiable and, therefore, are not distinct. The entity accounts for all of the goods and services promised in the contract as a single performance obligation.

Example 11—Determining whether goods or services are distinct

Case A—Distinct goods or services

- IE49 An entity, a software developer, enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the licence, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.
- IE50 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software licence transferred at the start of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 27(a) of IFRS 15 is met.
- IE51 The entity also considers the principle and the factors in paragraph 29 of IFRS 15 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus the criterion in paragraph 27(b) of IFRS 15 is met). In reaching this determination, the entity considers that, although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software licence because the installation services are routine and can be obtained from alternative providers. The software updates do not significantly affect the customer's ability to use and benefit from the software licence during the licence period. The entity further observes that none of the promised goods or services significantly modify or customise one another, nor is the entity providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated, because the entity would be able to fulfil its promise to transfer the initial software licence independently from its promise to subsequently provide the installation service, software updates or technical support.
- IE52 On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:
- (a) the software licence;
 - (b) an installation service;
 - (c) software updates; and

(d) technical support.

IE53 The entity applies paragraphs 31–38 of IFRS 15 to determine whether each of the performance obligations for the installation service, software updates and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software licence in accordance with paragraph B58 of IFRS 15 (see Example 54 in paragraphs IE276–IE277).

Case B—Significant customisation

IE54 The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

IE55 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity first assesses whether the criterion in paragraph 27(a) has been met. For the same reasons as in Case A, the entity determines that the software licence, installation, software updates and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 27(b) has been met by evaluating the principle and the factors in paragraph 29 of IFRS 15. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licenced software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the licence and the customised installation service as inputs to produce the combined output (ie a functional and integrated software system) specified in the contract (see paragraph 29(a) of IFRS 15). The software is significantly modified and customised by the service (see paragraph 29(b) of IFRS 15). Consequently, the entity determines that the promise to transfer the licence is not separately identifiable from the customised installation service and, therefore, the criterion in paragraph 27(b) of IFRS 15 is not met. Thus, the software licence and the customised installation service are not distinct.

IE56 On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

IE57 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

- (a) software customisation (which comprises the licence for the software and the customised installation service);
- (b) software updates; and
- (c) technical support.

IE58 The entity applies paragraphs 31–38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Case C—Promises are separately identifiable (installation)

- IE58A An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customisation or modification. The installation required is not complex and is capable of being performed by several alternative service providers.
- IE58B The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 27 of IFRS 15 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 27(a) of IFRS 15. The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (ie the equipment).
- IE58C The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 27(b) of IFRS 15). The entity considers the principle and the factors in paragraph 29 of IFRS 15 in determining that the equipment and the installation services are not inputs to a combined item in this contract. In this case, each of the factors in paragraph 29 of IFRS 15 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:
- (a) The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfil its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.
 - (b) The entity's installation services will not significantly customise or significantly modify the equipment.
 - (c) Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfil its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

- (i) the equipment; and
- (ii) installation services.

- IE58D The entity applies paragraphs 31–38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Case D—Promises are separately identifiable (contractual restrictions)

- IE58E Assume the same facts as in Case C, except that the customer is contractually required to use the entity's installation services.

- IE58F The contractual requirement to use the entity's installation services does not change the evaluation of whether the promised goods and services are distinct in this case. This is because the contractual requirement to use the entity's installation services does not change the characteristics of the goods or services themselves, nor does it change the entity's promises to the customer. Although the customer is required to use the entity's installation services, the equipment and the installation services are capable of being distinct (ie they each meet the criterion in paragraph 27(a) of IFRS 15) and the entity's promises to provide the equipment and to provide the installation services are each separately identifiable, ie they each meet the criterion in paragraph 27(b) of IFRS 15. The entity's analysis in this regard is consistent with that in Case C.

Case E—Promises are separately identifiable (consumables)

- IE58G An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (ie the equipment is operational without any significant customisation or modification) and to provide specialised consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.
- IE58H The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 28 of IFRS 15, because they are regularly sold separately by the entity (ie through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and the consumables are each capable of being distinct in accordance with paragraph 27(a) of IFRS 15.
- IE58I The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 27(b) of IFRS 15. In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. In addition, neither the equipment nor the consumables are significantly customised or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (ie the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfil each of its promises in the contract independently of the other. That is, the entity would be able to fulfil its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfil its promise to provide the consumables, even if the customer acquired the equipment separately.
- IE58J On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:
- (a) the equipment; and
 - (b) the consumables.
- IE5K The entity applies paragraphs 31–38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Example 12—Explicit and implicit promises in a contract

- IE59 An entity, a manufacturer, sells a product to a distributor (ie its customer) who will then resell it to an end customer.

Case A—Explicit promise of service

- IE60 In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (ie 'free') to any party (ie the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.
- IE61 The contract with the customer includes two promised goods or services—(a) the product and (b) the maintenance services. The promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor. The entity assesses whether each good or service is distinct in accordance with paragraph 27 of IFRS 15. The entity determines that both the product and the maintenance services meet the criterion in paragraph 27(a) of IFRS 15. The entity regularly sells the product on a stand-alone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (ie the product).
- IE61A The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 27(b) of IFRS 15) on the basis of the principle and the factors in paragraph 29 of IFRS 15. The product and the maintenance services are not inputs to a combined item in the contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customise the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to fulfil each of the promises in the contract independently of its efforts to fulfil the other (ie the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 29 of IFRS 15, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (ie the product and the maintenance services) in the contract.

Case B—Implicit promise of service

- IE62 The entity has historically provided maintenance services for no additional consideration (ie 'free') to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor and the final contract between the entity and the distributor does not specify terms or conditions for those services.
- IE63 However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (ie the distributor and end customers) in accordance with paragraph 24 of IFRS 15. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Case A, the entity determines that the product and maintenance services are separate performance obligations.

Case C—Services are not a promised service

- IE64 In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services and, therefore, the entity's customary business practices, published policies and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.
- IE65 The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 24 of IFRS 15, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- IE65A Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

Performance obligations satisfied over time

- IE66 Examples 13–17 illustrate the requirements in paragraphs 35–37 and B2–B13 of IFRS 15 on performance obligations satisfied over time. In addition, the following requirements are illustrated in these examples:
- (a) paragraphs 35(a) and B3–B4 of IFRS 15 on when a customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (Examples 13–14);
 - (b) paragraphs 35(c), 36–37 and B6–B13 of IFRS 15 on an entity's performance that does not create an asset with an alternative use and an entity's enforceable right to payment for performance completed to date (Examples 14–17); and
 - (c) paragraph 38 of IFRS 15 on performance obligations satisfied at a point in time (Example 17).

Example 13—Customer simultaneously receives and consumes the benefits

- IE67 An entity enters into a contract to provide monthly payroll processing services to a customer for one year.
- IE68 The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 22(b) of IFRS 15. The performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15 because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to re-perform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognises revenue over time by measuring its progress towards complete satisfaction of that performance obligation in accordance with paragraphs 39–45 and B14–B19 of IFRS 15.

Example 14—Assessing alternative use and right to payment

- IE69 An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 per cent margin. The 15 per cent margin approximates the profit margin that the entity earns from similar contracts.
- IE70 The entity considers the criterion in paragraph 35(a) of IFRS 15 and the requirements in paragraphs B3 and B4 of IFRS 15 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially re-perform the work that the entity had completed to date, because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 35(a) of IFRS 15 is not met.
- IE71 However, the entity's performance obligation meets the criterion in paragraph 35(c) of IFRS 15 and is a performance obligation satisfied over time because of both of the following factors:
- (a) in accordance with paragraphs 36 and B6–B8 of IFRS 15, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
 - (b) in accordance with paragraphs 37 and B9–B13 of IFRS 15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.
- IE72 Consequently, the entity recognises revenue over time by measuring the progress towards complete satisfaction of the performance obligation in accordance with paragraphs 39–45 and B14–B19 of IFRS 15.

Example 15—Asset has no alternative use to the entity

- IE73 An entity enters into a contract with a customer, a government agency, to build a specialised satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.
- IE74 At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 35 of IFRS 15.
- IE75 As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 35(c), 36 and B6–B8 of IFRS 15) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.
- IE76 For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 35(c) of IFRS 15 also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this example.

Example 16—Enforceable right to payment for performance completed to date

- IE77 An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 per cent of the contract price, regular payments throughout the construction period (amounting to 50 per cent of the contract price) and a final payment of 40 per cent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are non-refundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.
- IE78 At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 35 of IFRS 15.
- IE79 As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 35(c), 37 and B9–B13 of IFRS 15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are non-refundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.
- IE80 Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 35(c) of IFRS 15. Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 35(a) or (b) of IFRS 15 and thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 38 of IFRS 15.

Example 17—Assessing whether a performance obligation is satisfied at a point in time or over time

- IE81 An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A—Entity does not have an enforceable right to payment for performance completed to date

- IE82 The customer pays a deposit upon entering into the contract and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.
- IE83 At contract inception, the entity applies paragraph 35(c) of IFRS 15 to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because, until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work

completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 35(c) of IFRS 15. Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 38 of IFRS 15.

Case B—Entity has an enforceable right to payment for performance completed to date

- IE84 The customer pays a non-refundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.
- IE85 At contract inception, the entity applies paragraph 35(c) of IFRS 15 to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.
- IE86 The entity also has a right to payment for performance completed to date in accordance with paragraphs 37 and B9–B13 of IFRS 15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.
- IE87 Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 35(c) of IFRS 15 are met and the entity has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, the entity measures its progress towards complete satisfaction of its performance obligation in accordance with paragraphs 39–45 and B14–B19 of IFRS 15.
- IE88 In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (ie the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress towards complete satisfaction of its performance obligations in each contract.

Case C—Entity has an enforceable right to payment for performance completed to date

- IE89 The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

- IE90 Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity could also choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph B11 of IFRS 15), provided that the entity's rights to require the customer to continue to perform as required under the contract (ie pay the promised consideration) are enforceable.

Measuring progress towards complete satisfaction of a performance obligation

- IE91 Examples 18–19 illustrate the requirements in paragraphs 39–45 of IFRS 15 on measuring progress towards complete satisfaction of a performance obligation satisfied over time. Example 19 also illustrates the requirements in paragraph B19 of IFRS 15 on uninstalled materials when costs incurred are not proportionate to the entity's progress in satisfying a performance obligation.

Example 18—Measuring progress when making goods or services available

- IE92 An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay CU100 per month.
- IE93 The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15.
- IE94 The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure and it recognises revenue on a straight-line basis throughout the year at CU100 per month.

Example 19—Uninstalled materials

- IE95 In November 20X2, an entity contracts with a customer to refurbish a 3-storey building and install new elevators for total consideration of CU5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are CU4 million, including CU1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs B34–B38 of IFRS 15, because it obtains control of the elevators before they are transferred to the customer.

IE96 A summary of the transaction price and expected costs is as follows:

	CU
Transaction price	5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	<u>2,500,000</u>
Total expected costs	<u><u>4,000,000</u></u>

IE97 The entity uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation, in accordance with paragraph B19 of IFRS 15. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators (CU1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation (CU4 million). The entity is not involved in designing or manufacturing the elevators.

IE98 The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of IFRS 15, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (ie at a zero margin).

IE99 As of 31 December 20X2 the entity observes that:

- (a) other costs incurred (excluding elevators) are CU500,000; and
- (b) performance is 20 per cent complete (ie $\text{CU}500,000 \div \text{CU}2,500,000$).

IE100 Consequently, at 31 December 20X2, the entity recognises the following:

	CU
Revenue	2,200,000 ^(a)
Cost of goods sold	<u>2,000,000^(b)</u>
Profit	<u><u>200,000</u></u>

(a) Revenue recognised is calculated as $(20 \text{ per cent} \times \text{CU}3,500,000) + \text{CU}1,500,000$. (CU3,500,000 is CU5,000,000 transaction price – CU1,500,000 costs of elevators.)

(b) Cost of goods sold is CU500,000 of costs incurred + CU1,500,000 costs of elevators.

Variable consideration

IE101 Examples 20–21 illustrate the requirements in paragraphs 50–54 of IFRS 15 on identifying variable consideration.

Example 20—Penalty gives rise to variable consideration

- IE102 An entity enters into a contract with a customer to build an asset for CU1 million. In addition, the terms of the contract include a penalty of CU100,000 if the construction is not completed within three months of a date specified in the contract.
- IE103 The entity concludes that the consideration promised in the contract includes a fixed amount of CU900,000 and a variable amount of CU100,000 (arising from the penalty).
- IE104 The entity estimates the variable consideration in accordance with paragraphs 50–54 of IFRS 15 and considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration.

Example 21—Estimating variable consideration

- IE105 An entity enters into a contract with a customer to build a customised asset. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is CU2.5 million, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after 31 March 20X7 that the asset is incomplete, the promised consideration is reduced by CU10,000. For each day before 31 March 20X7 that the asset is complete, the promised consideration increases by CU10,000.
- IE106 In addition, upon completion of the asset, a third party will inspect the asset and assign a rating based on metrics that are defined in the contract. If the asset receives a specified rating, the entity will be entitled to an incentive bonus of CU150,000.
- IE107 In determining the transaction price, the entity prepares a separate estimate for each element of variable consideration to which the entity will be entitled using the estimation methods described in paragraph 53 of IFRS 15:
- (a) the entity decides to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive (ie CU2.5 million, plus or minus CU10,000 per day). This is because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.
 - (b) the entity decides to use the most likely amount to estimate the variable consideration associated with the incentive bonus. This is because there are only two possible outcomes (CU150,000 or CU0) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.
- IE108 The entity considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration to determine whether the entity should include some or all of its estimate of variable consideration in the transaction price.

Constraining estimates of variable consideration

- IE109 Examples 22–25 illustrate the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration. In addition, the following requirements are illustrated in these examples:
- (a) paragraph 55 of IFRS 15 on refund liabilities (Example 22);
 - (b) paragraphs B20–B27 of IFRS 15 on sales with a right of return (Example 22); and

- (c) paragraphs 84–86 of IFRS 15 on allocating variable consideration to performance obligations (Example 25).

Example 22—Right of return

- IE110 An entity enters into 100 contracts with customers. Each contract includes the sale of one product for CU100 (100 total products $\times$ CU100 = CU10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is CU60.
- IE111 The entity applies the requirements in IFRS 15 to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 4, the effects on the financial statements from applying these requirements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio.
- IE112 Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.
- IE113 The entity also considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of CU9,700 (CU100 $\times$ 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (ie the 30-day return period). Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU9,700) will not occur as the uncertainty is resolved (ie over the return period).
- IE114 The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.
- IE115 Upon transfer of control of the 100 products, the entity does not recognise revenue for the three products that it expects to be returned. Consequently, in accordance with paragraphs 55 and B21 of IFRS 15, the entity recognises the following:
- (a) revenue of CU9,700 (CU100 $\times$ 97 products not expected to be returned);
 - (b) a refund liability of CU300 (CU100 refund $\times$ 3 products expected to be returned); and
 - (c) an asset of CU180 (CU60 $\times$ 3 products for its right to recover products from customers on settling the refund liability).

Example 23—Price concessions

- IE116 An entity enters into a contract with a customer, a distributor, on 1 December 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of CU100 per product (total consideration is CU100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on 1 December 20X7.
- IE117 On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to

discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A—Estimate of variable consideration is not constrained

- IE118 The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 per cent of the sales price for these products. Current market information suggests that a 20 per cent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 per cent in many years.
- IE119 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be CU80,000 (CU80 × 1,000 products).
- IE120 The entity also considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of CU80,000 can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU80,000) will not occur when the uncertainty is resolved (ie when the total amount of price concessions is determined). Consequently, the entity recognises CU80,000 as revenue when the products are transferred on 1 December 20X7.

Case B—Estimate of variable consideration is constrained

- IE121 The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20–60 per cent of the sales price for similar products. Current market information also suggests that a 15–50 per cent reduction in price may be necessary to move the products through the distribution chain.
- IE122 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 per cent will be provided and, therefore, the estimate of the variable consideration is CU60,000 (CU60 × 1,000 products).
- IE123 The entity also considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of CU60,000 can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (ie risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of CU60,000 (ie a discount of 40 per cent) in the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Although the entity's historical price concessions have ranged from 20–60 per cent, market information currently suggests that a price concession of 15–50 per cent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised will not occur if the entity includes CU50,000 in the transaction price (CU100 sales price and a 50 per cent price concession) and

therefore, recognises revenue at that amount. Therefore, the entity recognises revenue of CU50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 59 of IFRS 15.

Example 24—Volume discount incentive

- IE124 An entity enters into a contract with a customer on 1 January 20X8 to sell Product A for CU100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to CU90 per unit. Consequently, the consideration in the contract is variable.
- IE125 For the first quarter ended 31 March 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.
- IE126 The entity considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration, including the factors in paragraph 57 of IFRS 15. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU100 per unit) will not occur when the uncertainty is resolved (ie when the total amount of purchases is known). Consequently, the entity recognises revenue of CU7,500 (75 units × CU100 per unit) for the quarter ended 31 March 20X8.
- IE127 In May 20X8, the entity's customer acquires another company and in the second quarter ended 30 June 20X8 the entity sells an additional 500 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and therefore it will be required to retrospectively reduce the price per unit to CU90.
- IE128 Consequently, the entity recognises revenue of CU44,250 for the quarter ended 30 June 20X8. That amount is calculated from CU45,000 for the sale of 500 units (500 units × CU90 per unit) less the change in transaction price of CU750 (75 units × CU10 price reduction) for the reduction of revenue relating to units sold for the quarter ended 31 March 20X8 (see paragraphs 87 and 88 of IFRS 15).

Example 25—Management fees subject to the constraint

- IE129 On 1 January 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a two per cent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 per cent of the fund's return in excess of the return of an observable market index over the five-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.
- IE130 The entity accounts for the services as a single performance obligation in accordance with paragraph 22(b) of IFRS 15, because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).
- IE131 At contract inception, the entity considers the requirements in paragraphs 50–54 of IFRS 15 on estimating variable consideration and the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration, including the factors in paragraph 57 of IFRS 15. The entity observes that the promised consideration is dependent on the market and thus is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in

determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

- IE132 At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the incentive fee in the transaction price. At 31 March 20X8, the client's assets under management are CU100 million. Therefore, the resulting quarterly management fee and the transaction price is CU2 million.
- IE133 At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 84(b) and 85 of IFRS 15. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 73 of IFRS 15. Consequently, the entity recognises CU2 million as revenue for the quarter ended 31 March 20X8.

The existence of a significant financing component in the contract

- IE134 Examples 26–30 illustrate the requirements in paragraphs 60–65 of IFRS 15 on the existence of a significant financing component in the contract. In addition, the following requirements are illustrated in Example 26:
- (a) paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration; and
 - (b) paragraphs B20–B27 of IFRS 15 on sales with a right of return.

Example 26—Significant financing component and right of return

- IE135 An entity sells a product to a customer for CU121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.
- IE136 The cash selling price of the product is CU100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is CU80.
- IE137 The entity does not recognise revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur in accordance with paragraphs 56–58 of IFRS 15. Consequently, revenue is recognised after three months when the right of return lapses.
- IE138 The contract includes a significant financing component, in accordance with paragraphs 60–62 of IFRS 15. This is evident from the difference between the amount of promised consideration of CU121 and the cash selling price of CU100 at the date that the goods are transferred to the customer.

IE139 The contract includes an implicit interest rate of 10 per cent (ie the interest rate that over 24 months discounts the promised consideration of CU121 to the cash selling price of CU100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs B20–B27 of IFRS 15.

- (a) When the product is transferred to the customer, in accordance with paragraph B21 of IFRS 15:

Asset for right to recover product to be returned	CU80 ^(a)	
Inventory		CU80

(a) This example does not consider expected costs to recover the asset.

- (b) During the three-month right of return period, no interest is recognised in accordance with paragraph 65 of IFRS 15 because no contract asset or receivable has been recognised.

- (c) When the right of return lapses (the product is not returned):

Receivable	CU100 ^(a)	
Revenue		CU100
Cost of sales	CU80	
Asset for product to be returned		CU80

(a) The receivable recognised would be measured in accordance with IFRS 9. This example assumes there is no material difference between the fair value of the receivable at contract inception and the fair value of the receivable when it is recognised at the time the right of return lapses. In addition, this example does not consider the impairment accounting for the receivable.

IE140 Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with IFRS 9. In determining the effective interest rate in accordance with IFRS 9, the entity would consider the remaining contractual term.

Example 27—Withheld payments on a long-term contract

IE141 An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the entity's expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (ie retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.

IE142 The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 62(c) of IFRS 15. The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

Example 28—Determining the discount rate

- IE143 An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is CU1 million plus a five per cent contractual rate of interest, payable in 60 monthly instalments of CU18,871.

Case A—Contractual discount rate reflects the rate in a separate financing transaction

- IE144 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the five per cent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (ie the contractual rate of interest of five per cent reflects the credit characteristics of the customer).
- IE145 The market terms of the financing mean that the cash selling price of the equipment is CU1 million. This amount is recognised as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with IFRS 9.

Case B—Contractual discount rate does not reflect the rate in a separate financing transaction

- IE146 In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the five per cent contractual rate of interest is significantly lower than the 12 per cent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (ie the contractual rate of interest of five per cent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than CU1 million.
- IE147 In accordance with paragraph 64 of IFRS 15, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 per cent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is CU848,357 (60 monthly payments of CU18,871 discounted at 12 per cent). The entity recognises revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with IFRS 9.

Example 29—Advance payment and assessment of discount rate

- IE148 An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (ie the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options: payment of CU5,000 in two years when the customer obtains control of the asset or payment of CU4,000 when the contract is signed. The customer elects to pay CU4,000 when the contract is signed.
- IE149 The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.
- IE150 The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 64 of IFRS 15, the rate that should be used in adjusting the promised consideration is six per cent, which is the entity's incremental borrowing rate.
- IE151 The following journal entries illustrate how the entity would account for the significant financing component:

- (a) recognise a contract liability for the CU4,000 payment received at contract inception:

Cash	CU4,000	
Contract liability		CU4,000

- (b) during the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 65 of IFRS 15) and accretes the contract liability by recognising interest on CU4,000 at six per cent for two years:

Interest expense	CU494 ^(a)	
Contract liability		CU494

(a) $CU494 = CU4,000 \text{ contract liability} \times (6 \text{ per cent interest per year for two years})$.

- (b) recognise revenue for the transfer of the asset:

Contract liability	CU4,494	
Revenue		CU4,494

Example 30—Advance payment

- IE152 An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional CU300. Customers electing to buy this service must pay for it upfront (ie a monthly payment option is not available).
- IE153 To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximise profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (ie customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.
- IE154 In assessing the requirements in paragraph 62(c) of IFRS 15, the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Non-cash consideration

- IE155 Example 31 illustrates the requirements in paragraphs 66–69 of IFRS 15 on non-cash consideration. In addition, the following requirements are illustrated in this example:
- (a) paragraph 22 of IFRS 15 on identifying performance obligations; and
- (b) paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration.

Example 31—Entitlement to non-cash consideration

- IE156 An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1 January 20X1 and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 22(b) of IFRS 15. This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).
- IE157 In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.
- IE158 The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognised), the entity measures the fair value of 100 shares that are received upon completion of each weekly service. The entity does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

Consideration payable to a customer

- IE159 Example 32 illustrates the requirements in paragraphs 70–72 of IFRS 15 on consideration payable to a customer.

Example 32—Consideration payable to a customer

- IE160 An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least CU15 million of products during the year. The contract also requires the entity to make a non-refundable payment of CU1.5 million to the customer at the inception of the contract. The CU1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.
- IE161 The entity considers the requirements in paragraphs 70–72 of IFRS 15 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 70 of IFRS 15, the CU1.5 million payment is a reduction of the transaction price.
- IE162 The entity applies the requirements in paragraph 72 of IFRS 15 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 per cent (CU1.5 million ÷ CU15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of CU1.8 million (CU2.0 million invoiced amount less CU0.2 million of consideration payable to the customer).

Allocating the transaction price to performance obligations

- IE163 Examples 33–35 illustrate the requirements in paragraphs 73–86 of IFRS 15 on allocating the transaction price to performance obligations. In addition, the following requirements are illustrated in Example 35:
- (a) paragraph 53 of IFRS 15 on variable consideration; and

- (b) paragraph B63 of IFRS 15 on consideration in the form of sales-based or usage-based royalties on licences of intellectual property.

Example 33—Allocation methodology

IE164 An entity enters into a contract with a customer to sell Products A, B and C in exchange for CU100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

IE165 Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs (in accordance with paragraph 78 of IFRS 15). The entity estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price	Method
CU		
Product A	50	Directly observable (see paragraph 77 of IFRS 15)
Product B	25	Adjusted market assessment approach (see paragraph 79(a) of IFRS 15)
Product C	75	Expected cost plus a margin approach (see paragraph 79(b) of IFRS 15)
Total	<u>150</u>	

IE166 The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (CU150) exceeds the promised consideration (CU100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 82 of IFRS 15) and concludes that it does not. Consequently, in accordance with paragraphs 76 and 81 of IFRS 15, the discount is allocated proportionately across Products A, B and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price
CU	
Product A	33 (CU50 ÷ CU150 × CU100)
Product B	17 (CU25 ÷ CU150 × CU100)
Product C	<u>50</u> (CU75 ÷ CU150 × CU100)
Total	<u>100</u>

Example 34—Allocating a discount

IE167 An entity regularly sells Products A, B and C individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone selling price
CU	
Product A	40
Product B	55
Product C	<u>45</u>
Total	<u>140</u>

IE168 In addition, the entity regularly sells Products B and C together for CU60.

Case A—Allocating a discount to one or more performance obligations

IE169 The entity enters into a contract with a customer to sell Products A, B and C in exchange for CU100. The entity will satisfy the performance obligations for each of the products at different points in time.

IE170 The contract includes a discount of CU40 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method (in accordance with paragraph 81 of IFRS 15). However, because the entity regularly sells Products B and C together for CU60 and Product A for CU40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 82 of IFRS 15.

IE171 If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate CU60 of the transaction price to the single performance obligation and recognise revenue of CU60 when Products B and C simultaneously transfer to the customer.

IE172 If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of CU60 is individually allocated to the promises to transfer Product B (stand-alone selling price of CU55) and Product C (stand-alone selling price of CU45) as follows:

Product	Allocated transaction price
CU	
Product B	33 (CU55 ÷ CU100 total stand-alone selling price × CU60)
Product C	<u>27</u> (CU45 ÷ CU100 total stand-alone selling price × CU60)
Total	<u>60</u>

Case B—Residual approach is appropriate

- IE173 The entity enters into a contract with a customer to sell Products A, B and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is CU130. The stand-alone selling price for Product D is highly variable (see paragraph 79(c) of IFRS 15) because the entity sells Product D to different customers for a broad range of amounts (CU15–CU45). Consequently, the entity decides to estimate the stand-alone selling price of Product D using the residual approach.
- IE174 Before estimating the stand-alone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 82 and 83 of IFRS 15.
- IE175 As in Case A, because the entity regularly sells Products B and C together for CU60 and Product A for CU40, it has observable evidence that CU100 should be allocated to those three products and a CU40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 82 of IFRS 15. Using the residual approach, the entity estimates the stand-alone selling price of Product D to be CU30 as follows:

Product	Stand-alone selling price	Method
CU		
Product A	40	Directly observable (see paragraph 77 of IFRS 15)
Products B and C	60	Directly observable with discount (see paragraph 82 of IFRS 15)
Product D	<u>30</u>	Residual approach (see paragraph 79(c) of IFRS 15)
Total	<u><u>130</u></u>	

- IE176 The entity observes that the resulting CU30 allocated to Product D is within the range of its observable selling prices (CU15–CU45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 73 of IFRS 15 and the requirements in paragraph 78 of IFRS 15.

Case C—Residual approach is inappropriate

- IE177 The same facts as in Case B apply to Case C except the transaction price is CU105 instead of CU130. Consequently, the application of the residual approach would result in a stand-alone selling price of CU5 for Product D (CU105 transaction price less CU100 allocated to Products A, B and C). The entity concludes that CU5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D, because CU5 does not approximate the stand-alone selling price of Product D, which ranges from CU15–CU45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the stand-alone selling price of Product D using another suitable method. The entity allocates the transaction price of CU130 to Products A, B, C and D using the relative stand-alone selling prices of those products in accordance with paragraphs 73–80 of IFRS 15.

Example 35—Allocation of variable consideration

- IE178 An entity enters into a contract with a customer for two intellectual property licences (Licences X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences X and Y are CU800 and CU1,000, respectively.

Case A—Variable consideration allocated entirely to one performance obligation

- IE179 The price stated in the contract for Licence X is a fixed amount of CU800 and for Licence Y the consideration is three per cent of the customer's future sales of products that use Licence Y. For purposes of allocation, the entity estimates its sales-based royalties (ie the variable consideration) to be CU1,000, in accordance with paragraph 53 of IFRS 15.
- IE180 To allocate the transaction price, the entity considers the criteria in paragraph 85 of IFRS 15 and concludes that the variable consideration (ie the sales-based royalties) should be allocated entirely to Licence Y. The entity concludes that the criteria in paragraph 85 of IFRS 15 are met for the following reasons:
- (a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence Y (ie the customer's subsequent sales of products that use Licence Y).
 - (b) allocating the expected royalty amounts of CU1,000 entirely to Licence Y is consistent with the allocation objective in paragraph 73 of IFRS 15. This is because the entity's estimate of the amount of sales-based royalties (CU1,000) approximates the stand-alone selling price of Licence Y and the fixed amount of CU800 approximates the stand-alone selling price of Licence X. The entity allocates CU800 to Licence X in accordance with paragraph 86 of IFRS 15. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 73 of IFRS 15.
- IE181 The entity transfers Licence Y at inception of the contract and transfers Licence X one month later. Upon the transfer of Licence Y, the entity does not recognise revenue because the consideration allocated to Licence Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph B63 of IFRS 15, the entity recognises revenue for the sales-based royalty when those subsequent sales occur.
- IE182 When Licence X is transferred, the entity recognises as revenue the CU800 allocated to Licence X.

Case B—Variable consideration allocated on the basis of stand-alone selling prices

- IE183 The price stated in the contract for Licence X is a fixed amount of CU300 and for Licence Y the consideration is five per cent of the customer's future sales of products that use Licence Y. The entity's estimate of the sales-based royalties (ie the variable consideration) is CU1,500 in accordance with paragraph 53 of IFRS 15.
- IE184 To allocate the transaction price, the entity applies the criteria in paragraph 85 of IFRS 15 to determine whether to allocate the variable consideration (ie the sales-based royalties) entirely to Licence Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence Y (ie the customer's subsequent sales of products that use Licence Y), allocating the variable consideration entirely to Licence Y would be inconsistent with the principle for allocating the transaction price. Allocating CU300 to Licence X and CU1,500 to Licence Y does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences X and Y of CU800 and CU1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 76–80 of IFRS 15.

- IE185 The entity allocates the transaction price of CU300 to Licences X and Y on the basis of relative stand-alone selling prices of CU800 and CU1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, in accordance with paragraph B63 of IFRS 15, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognise revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).
- IE186 Licence Y is transferred to the customer at the inception of the contract and Licence X is transferred three months later. When Licence Y is transferred, the entity recognises as revenue the CU167 ($\text{CU1,000} \div \text{CU1,800} \times \text{CU300}$) allocated to Licence Y. When Licence X is transferred, the entity recognises as revenue the CU133 ($\text{CU800} \div \text{CU1,800} \times \text{CU300}$) allocated to Licence X.
- IE187 In the first month, the royalty due from the customer's first month of sales is CU200. Consequently, in accordance with paragraph B63 of IFRS 15, the entity recognises as revenue the CU111 ($\text{CU1,000} \div \text{CU1,800} \times \text{CU200}$) allocated to Licence Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognises a contract liability for the CU89 ($\text{CU800} \div \text{CU1,800} \times \text{CU200}$) allocated to Licence X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

Contract costs

- IE188 Examples 36–37 illustrate the requirements in paragraphs 91–94 of IFRS 15 on incremental costs of obtaining a contract, paragraphs 95–98 of IFRS 15 on costs to fulfil a contract and paragraphs 99–104 of IFRS 15 on amortisation and impairment of contract costs.

Example 36—Incremental costs of obtaining a contract

- IE189 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

	CU
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	<u>10,000</u>
Total costs incurred	<u><u>50,000</u></u>

- IE190 In accordance with paragraph 91 of IFRS 15, the entity recognises an asset for the CU10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity and individual performance evaluations. In accordance with paragraph 91 of IFRS 15, the entity does not recognise an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.
- IE191 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 93 of IFRS 15, those costs are recognised as expenses when incurred, unless they are within the scope of another Standard, in which case, the relevant provisions of that Standard apply.

Example 37—Costs that give rise to an asset

- IE192 An entity enters into a service contract to manage a customer's information technology data centre for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a CU10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer, but will be used to deliver services to the customer.

Incremental costs of obtaining a contract

- IE193 In accordance with paragraph 91 of IFRS 15, the entity recognises an asset for the CU10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortises the asset over seven years in accordance with paragraph 99 of IFRS 15, because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

Costs to fulfil a contract

- IE194 The initial costs incurred to set up the technology platform are as follows:

	CU
Design services	40,000
Hardware	120,000
Software	90,000
Migration and testing of data centre	100,000
Total costs	<u>350,000</u>

- IE195 The initial setup costs relate primarily to activities to fulfil the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

- (a) hardware costs—accounted for in accordance with IAS 16 *Property, Plant and Equipment*.
- (b) software costs—accounted for in accordance with IAS 38 *Intangible Assets*.
- (c) costs of the design, migration and testing of the data centre—assessed in accordance with paragraph 95 of IFRS 15 to determine whether an asset can be recognised for the costs to fulfil the contract. Any resulting asset would be amortised on a systematic basis over the seven-year period (ie the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data centre.

- IE196 In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 95(b) of IFRS 15). Therefore, the costs do not meet the criteria in paragraph 95 of IFRS 15 and cannot be recognised as an asset using IFRS 15. In accordance with paragraph 98, the entity recognises the payroll expense for these two employees when incurred.

Presentation

IE197 Examples 38–40 illustrate the requirements in paragraphs 105–109 of IFRS 15 on the presentation of contract balances.

Example 38—Contract liability and receivable

Case A—Cancellable contract

IE198 On 1 January 20X9, an entity enters into a cancellable contract to transfer a product to a customer on 31 March 20X9. The contract requires the customer to pay consideration of CU1,000 in advance on 31 January 20X9. The customer pays the consideration on 1 March 20X9. The entity transfers the product on 31 March 20X9. The following journal entries illustrate how the entity accounts for the contract:

- (a) The entity receives cash of CU1,000 on 1 March 20X9 (cash is received in advance of performance):

Cash	CU1,000	
Contract liability		CU1,000

- (b) The entity satisfies the performance obligation on 31 March 20X9:

Contract liability	CU1,000	
Revenue		CU1,000

Case B—Non-cancellable contract

IE199 The same facts as in Case A apply to Case B except that the contract is non-cancellable. The following journal entries illustrate how the entity accounts for the contract:

- (a) The amount of consideration is due on 31 January 20X9 (which is when the entity recognises a receivable because it has an unconditional right to consideration):

Receivable	CU1,000	
Contract liability		CU1,000

- (b) The entity receives the cash on 1 March 20X9:

Cash	CU1,000	
Receivable		CU1,000

- (b) The entity satisfies the performance obligation on 31 March 20X9:

Contract liability	CU1,000	
Revenue		CU1,000

- IE200 If the entity issued the invoice before 31 January 20X9 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because the entity does not yet have a right to consideration that is unconditional.

Example 39—Contract asset recognised for the entity's performance

- IE201 On 1 January 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for CU1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of CU1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.
- IE202 The entity identifies the promises to transfer Products A and B as performance obligations and allocates CU400 to the performance obligation to transfer Product A and CU600 to the performance obligation to transfer Product B on the basis of their relative stand-alone selling prices. The entity recognises revenue for each respective performance obligation when control of the product transfers to the customer.

- IE203 The entity satisfies the performance obligation to transfer Product A:

Contract asset	CU400
Revenue	CU400

- IE204 The entity satisfies the performance obligation to transfer Product B and to recognise the unconditional right to consideration:

Receivable	CU1,000
Contract asset	CU400
Revenue	CU600

Example 40—Receivable recognised for the entity's performance

- IE205 An entity enters into a contract with a customer on 1 January 20X9 to transfer products to the customer for CU150 per product. If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is retrospectively reduced to CU125 per product.
- IE206 Consideration is due when control of the products transfer to the customer. Therefore, the entity has an unconditional right to consideration (ie a receivable) for CU150 per product until the retrospective price reduction applies (ie after 1 million products are shipped).

- IE207 In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold and therefore estimates that the transaction price is CU125 per product. Consequently, upon the first shipment to the customer of 100 products the entity recognises the following:

Receivable	CU15,000 ^(a)
Revenue	CU12,500 ^(b)
Refund liability (contract liability)	CU2,500

(a) CU150 per product × 100 products.

(b) CU125 transaction price per product × 100 products.

- IE208 The refund liability (see paragraph 55 of IFRS 15) represents a refund of CU25 per product, which is expected to be provided to the customer for the volume-based rebate (ie the difference between the CU150 price stated in the contract that the entity has an unconditional right to receive and the CU125 estimated transaction price).

Disclosure

- IE209 Example 41 illustrates the requirements in paragraphs 114–115 and B87–B89 of IFRS 15 on the disaggregation of revenue disclosure. Examples 42–43 illustrate the requirements in paragraphs 120–122 of IFRS 15 for the disclosure of the transaction price allocated to the remaining performance obligations. In addition, the following requirements are illustrated in Example 42:

- (a) paragraph 57 of IFRS 15 on constraining estimates of variable consideration; and
- (b) paragraph B16 of IFRS 15 on methods for measuring progress towards complete satisfaction of a performance obligation.

Example 41—Disaggregation of revenue—quantitative disclosure

- IE210 An entity reports the following segments: consumer products, transportation and energy, in accordance with IFRS 8 *Operating Segments*. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines and timing of revenue recognition (ie goods transferred at a point in time or services transferred over time).
- IE211 The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 114 of IFRS 15, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation and energy segments, in accordance with paragraph 115 of IFRS 15.

Segments	Consumer products	Transport	Energy	Total
	CU	CU	CU	CU
Primary geographical markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	–	960
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
Major goods/service lines				
Office supplies	600	–	–	600
Appliances	990	–	–	990
Clothing	400	–	–	400
Motorcycles	–	500	–	500
Automobiles	–	2,760	–	2,760
Solar panels	–	–	1,000	1,000
Power plant	–	–	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	–	–	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>

Example 42—Disclosure of the transaction price allocated to the remaining performance obligations

IE212 On 30 June 20X7, an entity enters into three contracts (Contracts A, B and C) with separate customers to provide services. Each contract has a two-year non-cancellable term. The entity considers the requirements in paragraphs 120–122 of IFRS 15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at 31 December 20X7.

Contract A

IE213 Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of CU25.

- IE214 Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph B16 of IFRS 15. Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 121(b) of IFRS 15.

Contract B

- IE215 Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of CU400 per month for both services. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.
- IE216 The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The information for Contract B included in the overall disclosure is as follows:

	20X8	20X9	Total
	CU	CU	CU
Revenue expected to be recognised on this contract as of 31 December 20X7	4,800 ^(a)	2,400 ^(b)	7,200

(a) CU4,800 = CU400 × 12 months.
(b) CU2,400 = CU400 × 6 months.

Contract C

- IE217 Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of CU100 per month plus a one-time variable consideration payment ranging from CU0–CU1,000 corresponding to a one-time regulatory review and certification of the customer's facility (ie a performance bonus). The entity estimates that it will be entitled to CU750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 57 of IFRS 15, the entity includes its estimate of CU750 of variable consideration in the transaction price because it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.
- IE218 The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows:

	20X8	20X9	Total
	CU	CU	CU
Revenue expected to be recognised on this contract as of 31 December 20X7	1,575 ^(a)	788 ^(b)	2,363

(a) Transaction price = CU3,150 (CU100 × 24 months + CU750 variable consideration) recognised evenly over 24 months at CU1,575 per year.
(b) CU1,575 ÷ 2 = CU788 (ie for 6 months of the year).

- IE219 In addition, in accordance with paragraph 122 of IFRS 15, the entity discloses qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price. That part of the performance bonus was excluded from the transaction price in accordance with the requirements for constraining estimates of variable consideration.

Example 43—Disclosure of the transaction price allocated to the remaining performance obligations—qualitative disclosure

- IE220 On 1 January 20X2, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of CU10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of 31 December 20X2, the entity has recognised CU3.2 million of revenue. The entity estimates that construction will be completed in 20X3, but it is possible that the project will be completed in the first half of 20X4.
- IE221 At 31 December 20X2, the entity discloses the amount of the transaction price that has not yet been recognised as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognise that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

‘As of 31 December 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is CU6.8 million and the entity will recognise this revenue as the building is completed, which is expected to occur over the next 12–18 months.’

Warranties

- IE222 Example 44 illustrates the requirements in paragraphs B28–B33 of IFRS 15 on warranties. In addition, Example 44 illustrates the requirements in paragraphs 27–29 of IFRS 15 on identifying performance obligations.

Example 44—Warranties

- IE223 An entity, a manufacturer, provides its customer with a warranty with the purchase of a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost.
- IE224 The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.
- IE225 The product and training services are each capable of being distinct in accordance with paragraphs 27(a) and 28 of IFRS 15, because the customer can benefit from the product on its own without the training services and can benefit from the training services together with the product that already has been transferred by the entity. The entity regularly sells the product separately without the training services.
- IE226 The entity next assesses whether its promises to transfer the product and to provide the training services are separately identifiable in accordance with paragraphs 27(b) and 29 of IFRS 15. The entity does not provide a significant service of integrating the training services with the product (see paragraph 29(a) of IFRS 15). The training services and product do not significantly modify or customise each other (see paragraph 29(b) of IFRS 15). The product and the training services are not highly interdependent ~~or~~, or highly interrelated (see paragraph 29(c) of IFRS 15). The entity would be able to fulfil its promise to transfer the product independently of its efforts to subsequently provide the training services, and would be able to provide training services to any customer that

had previously acquired its product. Consequently, the entity concludes that its promise to transfer the product and its promise to provide training services are not inputs to a combined item, and, therefore, are each separately identifiable.

- IE227 The product and training services are each distinct in accordance with paragraph 27 of IFRS 15 and therefore give rise to two separate performance obligations.
- IE228 Finally, the entity assesses the promise to provide a warranty and observes that the warranty provides the customer with the assurance that the product will function as intended for one year. The entity concludes, in accordance with paragraphs B28–B33 of IFRS 15, that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a performance obligation. The entity accounts for the assurance-type warranty in accordance with the requirements in IAS 37.
- IE229 As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognises revenue when (or as) those performance obligations are satisfied.

Principal versus agent considerations

- IE230 Examples 45–48A illustrate the requirements in paragraphs B34–B38 of IFRS 15 on principal versus agent considerations.

Example 45—Arranging for the provision of goods or services (entity is an agent)

- IE231 An entity operates a website that enables customers to purchase goods from a range of suppliers who deliver the goods directly to the customers. Under the terms of the entity's contracts with suppliers, when a good is purchased via the website, the entity is entitled to a commission that is equal to 10 per cent of the sales price. The entity's website facilitates payment between the supplier and the customer at prices that are set by the supplier. The entity requires payment from customers before orders are processed and all orders are non-refundable. The entity has no further obligations to the customer after arranging for the products to be provided to the customer.
- IE232 To determine whether the entity's performance obligation is to provide the specified goods itself (ie the entity is a principal) or to arrange for those goods to be provided by the supplier (ie the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.
- IE232A The website operated by the entity is a marketplace in which suppliers offer their goods and customers purchase the goods that are offered by the suppliers. Accordingly, the entity observes that the specified goods to be provided to customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to customers by the entity.
- IE232B The entity concludes that it does not control the specified goods before they are transferred to customers that order goods using the website. The entity does not at any time have the ability to direct the use of the goods transferred to customers. For example, it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer. The entity does not control the suppliers' inventory of goods used to fulfil the orders placed by customers using the website.
- IE232C As part of reaching that conclusion, the entity considers the following indicators in paragraph B37 of IFRS 15. The entity concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers:

- (a) the supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer, nor responsible for the acceptability of the goods.
- (b) the entity does not take inventory risk at any time before or after the goods are transferred to the customer. The entity does not commit itself to obtain the goods from the supplier before the goods are purchased by the customer, and does not accept responsibility for any damaged or returned goods.
- (c) the entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

IE233 Consequently, the entity concludes that it is an agent and its performance obligation is to arrange for the provision of goods by the supplier. When the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognises revenue in the amount of the commission to which it is entitled.

Example 46—Promise to provide goods or services (entity is a principal)

IE234 An entity enters into a contract with a customer for equipment with unique specifications. The entity and the customer develop the specifications for the equipment, which the entity communicates to a supplier that the entity contracts with to manufacture the equipment. The entity also arranges to have the supplier deliver the equipment directly to the customer. Upon delivery of the equipment to the customer, the terms of the contract require the entity to pay the supplier the price agreed to by the entity and the supplier for manufacturing the equipment.

IE235 The entity and the customer negotiate the selling price and the entity invoices the customer for the agreed-upon price with 30-day payment terms. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.

IE236 The contract between the entity and the customer requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty. However, the entity is responsible for any corrections to the equipment required resulting from errors in specifications.

IE237 To determine whether the entity's performance obligation is to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by another party (ie the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

IE237A The entity concludes that it has promised to provide the customer with specialised equipment designed by the entity. Although the entity has subcontracted the manufacturing of the equipment to the supplier, the entity concludes that the design and manufacturing of the equipment are not distinct, because they are not separately identifiable (ie there is a single performance obligation). The entity is responsible for the overall management of the contract (for example, by ensuring that the manufacturing service conforms to the specifications) and, thus, provides a significant service of integrating those items into the combined output—the specialised equipment—for which the customer has contracted. In addition, those activities are highly interrelated. If necessary modifications to the specifications are identified as the equipment is manufactured, the entity is responsible for developing and communicating revisions to the supplier and for ensuring that any associated rework required conforms with the revised specifications. Accordingly, the entity identifies the specified good to be provided to the customer as the specialised equipment.

IE237B The entity concludes that it controls the specialised equipment before that equipment is transferred to the customer (see paragraph B35A(c)). The entity provides the significant integration service necessary to produce the specialised equipment and, therefore, controls the specialised

equipment before it is transferred to the customer. The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialised equipment. In reaching the conclusion that it controls the specialised equipment before that equipment is transferred to the customer, the entity also observes that, even though the supplier delivers the specialised equipment to the customer, the supplier has no ability to direct its use (ie the terms of the contract between the entity and the supplier preclude the supplier from using the specialised equipment for another purpose or directing that equipment to another customer). The entity also obtains the remaining benefits from the specialised equipment by being entitled to the consideration in the contract from the customer.

- IE238 Thus, the entity concludes that it is a principal in the transaction. The entity does not consider the indicators in paragraph B37 of IFRS 15 because the evaluation above is conclusive without consideration of the indicators. The entity recognises revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the specialised equipment.

Example 46A—Promise to provide goods or services (entity is a principal)

- IE238A An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.
- IE238B The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers are generally aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.
- IE238C To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.
- IE238D The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted, and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.
- IE238E The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph B35A(b)). In addition, the entity concludes that the following indicators in paragraph B37 of IFRS 15 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:
- (a) the entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (ie the entity is responsible

for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).

- (b) the entity has discretion in setting the price for the services to the customer.

IE238F The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph IE238E.

IE238G Thus, the entity is a principal in the transaction and recognises revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

Example 47—Promise to provide goods or services (entity is a principal)

IE239 An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

IE240 The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased.

IE241 The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

IE242 To determine whether the entity's performance obligation is to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by another party (ie the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

IE242A The entity concludes that, with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph B35A(a)). Consequently, the entity determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

IE242B The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfil a contract with a customer and, if so, which contract it will fulfil. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

IE242C The indicators in paragraphs B37(b)–(c) of IFRS 15 also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favourable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

- IE243 Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognises revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

Example 48—Arranging for the provision of goods or services (entity is an agent)

- IE244 An entity sells vouchers that entitle customers to future meals at specified restaurants. The sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays CU100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost CU200). The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website and the vouchers are non-refundable.
- IE245 The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. Under the terms of its contracts with the restaurants, the entity is entitled to 30 per cent of the voucher price when it sells the voucher.
- IE246 The entity also assists the customers in resolving complaints about the meals and has a buyer satisfaction programme. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.
- IE247 To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer.
- IE247A A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf as described in the indicator in paragraph B37(a) of IFRS 15. Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person. The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.
- IE247B The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:
- (a) the vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers, or obtain substantially all of the remaining benefits from the vouchers, before they are transferred to customers.
 - (b) the entity neither purchases, nor commits itself to purchase, vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk with respect to the vouchers as described in the indicator in paragraph B37(b) of IFRS 15.
- IE248 Thus, the entity concludes that it is an agent with respect to the vouchers. The entity recognises revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 per cent commission it is entitled to upon the sale of each voucher.

Example 48A—Entity is a principal and an agent in the same contract

- IE248A An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a licence to access a third party's database of information on potential recruits. The entity arranges for this licence with the third party, but the customer contracts directly with the database provider for the licence. The entity collects payment on behalf of the third-party database provider as part of the entity's overall invoicing to the customer. The database provider sets the price charged to the customer for the licence, and is responsible for providing technical support and credits to which the customer may be entitled for service down time or other technical issues.
- IE248B To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer, and assesses whether it controls those goods or services before they are transferred to the customer.
- IE248C For the purpose of this example, it is assumed that the entity concludes that its recruitment services and the database access licence are each distinct on the basis of its assessment of the requirements in paragraphs 27–30 of IFRS 15. Accordingly, there are two specified goods or services to be provided to the customer—access to the third party's database and recruitment services.
- IE248D The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the licence because the customer contracts for the licence directly with the database provider. The entity does not control access to the provider's database—it cannot, for example, grant access to the database to a party other than the customer, or prevent the database provider from providing access to the customer.
- IE248E As part of reaching that conclusion, the entity also considers the indicators in paragraph B37 of IFRS 15. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer:
- (a) the entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the licence directly with the third-party database provider and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).
 - (b) the entity does not have inventory risk because it does not purchase, or commit itself to purchase, the database access before the customer contracts for database access directly with the database provider.
 - (c) the entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.
- IE248F Thus, the entity concludes that it is an agent in relation to the third party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.

Customer options for additional goods or services

- IE249 Examples 49–52 illustrate the requirements in paragraphs B39–B43 of IFRS 15 on customer options for additional goods or services. Example 50 illustrates the requirements in paragraphs 27–29 of IFRS 15 on identifying performance obligations. Example 52 illustrates a customer loyalty programme. That example may not apply to all customer loyalty arrangements because the terms

and conditions may differ. In particular, when there are more than two parties to the arrangement, an entity should consider all facts and circumstances to determine the customer in the transaction that gives rise to the award credits.

Example 49—Option that provides the customer with a material right (discount voucher)

- IE250 An entity enters into a contract for the sale of Product A for CU100. As part of the contract, the entity gives the customer a 40 per cent discount voucher for any future purchases up to CU100 in the next 30 days. The entity intends to offer a 10 per cent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 per cent discount cannot be used in addition to the 40 per cent discount voucher.
- IE251 Because all customers will receive a 10 per cent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 per cent (ie the additional 30 per cent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.
- IE252 To estimate the stand-alone selling price of the discount voucher in accordance with paragraph B42 of IFRS 15, the entity estimates an 80 per cent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase CU50 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is CU12 (CU50 average purchase price of additional products × 30 per cent incremental discount × 80 per cent likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the CU100 transaction price are as follows:

Performance obligation	Stand-alone selling price
	CU
Product A	100
Discount voucher	<u>12</u>
Total	<u>112</u>
	Allocated transaction price
Product A	89 (CU100 ÷ CU112 × CU100)
Discount voucher	<u>11</u> (CU12 ÷ CU112 × CU100)
Total	<u>100</u>

- IE253 The entity allocates CU89 to Product A and recognises revenue for Product A when control transfers. The entity allocates CU11 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

Example 50—Option that does not provide the customer with a material right (additional goods or services)

- IE254 An entity in the telecommunications industry enters into a contract with a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the

price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their stand-alone selling prices.

- IE255 The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 27(a) of IFRS 15. In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15).
- IE256 The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph B41 of IFRS 15). This is because the prices of the additional call minutes and texts reflect the stand-alone selling prices for those services. Because the option for additional call minutes and texts does not grant the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional call minutes or texts. The entity will recognise revenue for the additional call minutes or texts if and when the entity provides those services.

Example 51—Option that provides the customer with a material right (renewal option)

- IE257 An entity enters into 100 separate contracts with customers to provide one year of maintenance services for CU1,000 per contract. The terms of the contracts specify that at the end of the year, each customer has the option to renew the maintenance contract for a second year by paying an additional CU1,000. Customers who renew for a second year are also granted the option to renew for a third year for CU1,000. The entity charges significantly higher prices for maintenance services to customers that do not sign up for the maintenance services initially (ie when the products are new). That is, the entity charges CU3,000 in Year 2 and CU5,000 in Year 3 for annual maintenance services if a customer does not initially purchase the service or allows the service to lapse.
- IE258 The entity concludes that the renewal option provides a material right to the customer that it would not receive without entering into the contract, because the price for maintenance services are significantly higher if the customer elects to purchase the services only in Year 2 or 3. Part of each customer's payment of CU1,000 in the first year is, in effect, a non-refundable prepayment of the services to be provided in a subsequent year. Consequently, the entity concludes that the promise to provide the option is a performance obligation.
- IE259 The renewal option is for a continuation of maintenance services and those services are provided in accordance with the terms of the existing contract. Instead of determining the stand-alone selling prices for the renewal options directly, the entity allocates the transaction price by determining the consideration that it expects to receive in exchange for all the services that it expects to provide, in accordance with paragraph B43 of IFRS 15.
- IE260 The entity expects 90 customers to renew at the end of Year 1 (90 per cent of contracts sold) and 81 customers to renew at the end of Year 2 (90 per cent of the 90 customers that renewed at the end of Year 1 will also renew at the end of Year 2, that is 81 per cent of contracts sold).
- IE261 At contract inception, the entity determines the expected consideration for each contract is CU2,710 [CU1,000 + (90 per cent × CU1,000) + (81 per cent × CU1,000)]. The entity also determines that recognising revenue on the basis of costs incurred relative to the total expected costs depicts the transfer of services to the customer. Estimated costs for a three-year contract are as follows:

	CU
Year 1	600
Year 2	750

	CU
Year 3	1,000

- IE262 Accordingly, the pattern of revenue recognition expected at contract inception for each contract is as follows:

	Expected costs adjusted for likelihood of contract renewal		Allocation of consideration expected	
	CU		CU	
Year 1	600	(CU600 × 100%)	780	[(CU600 ÷ CU2,085) × CU2,710]
Year 2	675	(CU750 × 90%)	877	[(CU675 ÷ CU2,085) × CU2,710]
Year 3	810	(CU1,000 × 81%)	1,053	[(CU810 ÷ CU2,085) × CU2,710]
Total	<u>2,085</u>		<u>2,710</u>	

- IE263 Consequently, at contract inception, the entity allocates to the option to renew at the end of Year 1 CU22,000 of the consideration received to date [cash of CU100,000 – revenue to be recognised in Year 1 of CU78,000 (CU780 × 100)].
- IE264 Assuming there is no change in the entity's expectations and the 90 customers renew as expected, at the end of the first year, the entity has collected cash of CU190,000 [(100 × CU1,000) + (90 × CU1,000)], has recognised revenue of CU78,000 (CU780 × 100) and has recognised a contract liability of CU112,000.
- IE265 Consequently, upon renewal at the end of the first year, the entity allocates CU24,300 to the option to renew at the end of Year 2 [cumulative cash of CU190,000 less cumulative revenue recognised in Year 1 and to be recognised in Year 2 of CU165,700 (CU78,000 + CU877 × 100)].
- IE266 If the actual number of contract renewals was different than what the entity expected, the entity would update the transaction price and the revenue recognised accordingly.

Example 52—Customer loyalty programme

- IE267 An entity has a customer loyalty programme that rewards a customer with one customer loyalty point for every CU10 of purchases. Each point is redeemable for a CU1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for CU100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is CU100,000. The entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of CU0.95 per point (totalling CU9,500) on the basis of the likelihood of redemption in accordance with paragraph B42 of IFRS 15.
- IE268 The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price (CU100,000) to the product and the points on a relative stand-alone selling price basis as follows:

CU

Product	91,324	$[\text{CU}100,000 \times (\text{CU}100,000 \text{ stand-alone selling price} \div \text{CU}109,500)]$
Points	8,676	$[\text{CU}100,000 \times (\text{CU}9,500 \text{ stand-alone selling price} \div \text{CU}109,500)]$

- IE269 At the end of the first reporting period, 4,500 points have been redeemed and the entity continues to expect 9,500 points to be redeemed in total. The entity recognises revenue for the loyalty points of CU4,110 $[(4,500 \text{ points} \div 9,500 \text{ points}) \times \text{CU}8,676]$ and recognises a contract liability of CU4,566 $(\text{CU}8,676 - \text{CU}4,110)$ for the unredeemed points at the end of the first reporting period.
- IE270 At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognises revenue for the loyalty points of CU3,493 $\{[(8,500 \text{ total points redeemed} \div 9,700 \text{ total points expected to be redeemed}) \times \text{CU}8,676 \text{ initial allocation}] - \text{CU}4,110 \text{ recognised in the first reporting period}\}$. The contract liability balance is CU1,073 $(\text{CU}8,676 \text{ initial allocation} - \text{CU}7,603 \text{ of cumulative revenue recognised})$.

Non-refundable upfront fees

- IE271 Example 53 illustrates the requirements in paragraphs B48–B51 of IFRS 15 on non-refundable upfront fees.

Example 53—Non-refundable upfront fee

- IE272 An entity enters into a contract with a customer for one year of transaction processing services. The entity's contracts have standard terms that are the same for all customers. The contract requires the customer to pay an upfront fee to set up the customer on the entity's systems and processes. The fee is a nominal amount and is non-refundable. The customer can renew the contract each year without paying an additional fee.
- IE273 The entity's setup activities do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.
- IE274 The entity concludes that the renewal option does not provide a material right to the customer that it would not receive without entering into that contract (see paragraph B40 of IFRS 15). The upfront fee is, in effect, an advance payment for the future transaction processing services. Consequently, the entity determines the transaction price, which includes the non-refundable upfront fee, and recognises revenue for the transaction processing services as those services are provided in accordance with paragraph B49 of IFRS 15.

Licensing

- IE275 Examples 54–61 illustrate the requirements in paragraphs 22–30 of IFRS 15 for identifying performance obligations and paragraphs B52–B63B of IFRS 15 on licensing. These examples also illustrate other requirements as follows:
- paragraphs 39–45 of IFRS 15 on measuring progress towards complete satisfaction of a performance obligation (Example 58);
 - paragraphs 84–86 of IFRS 15 on allocating variable consideration to performance obligations (Example 57); and
 - paragraph B63-B63B of IFRS 15 on consideration in the form of sales-based or usage-based royalties on licences of intellectual property (Examples 57 and 61).

Example 54—Right to use intellectual property

IE276 Using the same facts as in Case A in Example 11 (see paragraphs IE49–IE53), the entity identifies four performance obligations in a contract:

- (a) the software licence;
- (b) installation services;
- (c) software updates; and
- (d) technical support.

IE277 The entity assesses the nature of its promise to transfer the software licence in accordance with paragraph B58 of IFRS 15. The entity does not consider in its assessment of the criteria in paragraph B58 of IFRS 15 the promise to provide software updates, because they result in the transfer of an additional good or service to the customer (see paragraph B58(c)). The entity also observes that it does not have any contractual or implied obligations (independent of the updates and technical support) to undertake activities that will change the functionality of the software during the licence period. The entity observes that the software remains functional without the updates and the technical support and, therefore, the ability of the customer to obtain the benefits of the software is not substantially derived from, or dependent on, the entity's ongoing activities. The entity therefore determines that the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the software (independent of the updates and technical support). The entity concludes that the software to which the licence relates has significant stand-alone functionality and none of the criteria in paragraph B58 of IFRS 15 are met. The entity further concludes that the nature of the entity's promise in transferring the licence is to provide a right to use the entity's intellectual property as it exists at a point in time. Consequently, the entity accounts for the licence as a performance obligation satisfied at a point in time.

Example 55—Licence of intellectual property

IE278 An entity enters into a contract with a customer to licence (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the licence during the licence period, because the intellectual property is used in an industry in which technologies change rapidly.

IE279 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity determines that the customer can benefit from (a) the licence on its own without the updates; and (b) the updates together with the initial licence. Although the benefit the customer can derive from the licence on its own (ie without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the licence can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 27(a) of IFRS 15 is met for the licence and the updates.

IE279A The fact that the benefit the customer can derive from the licence on its own (ie without the updates) is limited (because the updates are integral to the customer's ability to continue to use the licence in the rapidly changing technological environment) is also considered in assessing whether the criterion in paragraph 27(b) of IFRS 15 is met. Because the benefit that the customer could obtain from the licence over the three-year term without the updates would be significantly limited, the entity's promises to grant the licence and to provide the expected updates are, in effect, inputs that together fulfil a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the

contract. The promises within that combined item (ie to grant the licence and to provide when-and-if-available updates) are, therefore, not separately identifiable in accordance with the criterion in paragraph 27(b) of IFRS 15.

- IE280 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. On the basis of this conclusion, the entity applies paragraphs 31–38 of IFRS 15 to determine whether the single performance obligation is satisfied at a point in time or over time. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15.

Example 56—Identifying a distinct licence

- IE281 An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

Case A—Licence is not distinct

- IE282 In this case, no other entity can manufacture this drug because of the highly specialised nature of the manufacturing process. As a result, the licence cannot be purchased separately from the manufacturing services.
- IE283 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity determines that the customer cannot benefit from the licence without the manufacturing service; therefore, the criterion in paragraph 27(a) of IFRS 15 is not met. Consequently, the licence and the manufacturing service are not distinct and the entity accounts for the licence and the manufacturing service as a single performance obligation.
- IE284 The entity applies paragraphs 31–38 of IFRS 15 to determine whether the performance obligation (ie the bundle of the licence and the manufacturing services) is a performance obligation satisfied at a point in time or over time.

Case B—Licence is distinct

- IE285 In this case, the manufacturing process used to produce the drug is not unique or specialised and several other entities can also manufacture the drug for the customer.
- IE286 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 27 of IFRS 15 are met for each of the licence and the manufacturing service. The entity concludes that the criterion in paragraph 27(a) of IFRS 15 is met because the customer can benefit from the licence together with readily available resources other than the entity's manufacturing service (because there are other entities that can provide the manufacturing service), and can benefit from the manufacturing service together with the licence transferred to the customer at the start of the contract.

IE286A The entity also concludes that its promises to grant the licence and to provide the manufacturing service are separately identifiable (ie the criterion in paragraph 27(b) of IFRS 15 is met). The entity concludes that the licence and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 29 of IFRS 15. In reaching this conclusion, the entity considers that the customer could separately purchase the licence without significantly affecting its ability to benefit from the licence. Neither the licence, nor the manufacturing service, is significantly modified or customised by the other and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the licence and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfil its promise to transfer the licence independently of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the licence and initially utilised a different manufacturer. Thus, although the manufacturing service necessarily depends on the licence in this contract (ie the entity would not provide the manufacturing service without the customer having obtained the licence), the licence and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the licence and to provide the manufacturing service are distinct and that there are two performance obligations:

- (a) licence of patent rights; and
- (b) manufacturing service.

IE287 The entity assesses, in accordance with paragraph B58 of IFRS 15, the nature of the entity's promise to grant the licence. The drug is a mature product (ie it has been approved, is currently being manufactured and has been sold commercially for the last several years). For these types of mature products, the entity's customary business practices are not to undertake any activities to support the drug. The drug compound has significant stand-alone functionality (ie its ability to produce a drug that treats a disease or condition). Consequently, the customer obtains a substantial portion of the benefits of the drug compound from that functionality, rather than from the entity's ongoing activities. The entity concludes that the criteria in paragraph B58 of IFRS 15 are not met because the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the intellectual property to which the customer has rights. In its assessment of the criteria in paragraph B58 of IFRS 15, the entity does not take into consideration the separate performance obligation of promising to provide a manufacturing service. Consequently, the nature of the entity's promise in transferring the licence is to provide a right to use the entity's intellectual property in the form and the functionality with which it exists at the point in time that it is granted to the customer. Consequently, the entity accounts for the licence as a performance obligation satisfied at a point in time.

IE288 The entity applies paragraphs 31–38 of IFRS 15 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

Example 57—Franchise rights

IE289 An entity enters into a contract with a customer and promises to grant a franchise licence that provides the customer with the right to use the entity's trade name and sell the entity's products for 10 years. In addition to the licence, the entity also promises to provide the equipment necessary to operate a franchise store. In exchange for granting the licence, the entity receives a sales-based royalty of five per cent of the customer's monthly sales. The fixed consideration for the equipment is CU150,000 payable when the equipment is delivered.

Identifying performance obligations

- IE290 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity observes that the entity, as a franchisor, has developed a customary business practice to undertake activities such as analysing consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns and operational efficiencies to support the franchise name. However, the entity concludes that these activities do not directly transfer goods or services to the customer because they are part of the entity's promise to grant a licence.
- IE291 The entity determines that it has two promises to transfer goods or services: a promise to grant a licence and a promise to transfer equipment. In addition, the entity concludes that the promise to grant the licence and the promise to transfer the equipment are each distinct. This is because the customer can benefit from each good or service – (ie the licence and the equipment) on its own or together with other resources that are readily available (see paragraph 27(a) of IFRS 15). The customer can benefit from the licence together with the equipment that is delivered before the opening of the franchise and the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the promises to grant the franchise licence and to transfer the equipment are separately identifiable, in accordance with the criterion in paragraph 27(b) of IFRS 15. The entity concludes that the licence and the equipment are not inputs to a combined item (ie they are not fulfilling what is, in effect, a single promise to the customer). In reaching this conclusion, the entity considers that it is not providing a significant service of integrating the licence and the equipment into a combined item (ie the licensed intellectual property is not a component of, and does not significantly modify, the equipment). In addition, the licence and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfil each promise (ie to license the franchise or to transfer the equipment) independently of the other. Consequently, the entity has two performance obligations:
- (a) the franchise licence; and
 - (b) the equipment.

Allocating the transaction price

- IE292 The entity determines that the transaction price includes fixed consideration of CU150,000 and variable consideration (five per cent of customer sales). The stand-alone selling price of the equipment is CU150,000 and the entity regularly licenses franchises in exchange for five per cent of customer sales.
- IE293 The entity applies paragraph 85 of IFRS 15 to determine whether the variable consideration should be allocated entirely to the performance obligation to transfer the franchise licence. The entity concludes that the variable consideration (ie the sales-based royalty) should be allocated entirely to the franchise licence because the variable consideration relates entirely to the entity's promise to grant the franchise licence. In addition, the entity observes that allocating CU150,000 to the equipment and the sales-based royalty to the franchise licence would be consistent with an allocation based on the entity's relative stand-alone selling prices in similar contracts. Consequently, the entity concludes that the variable consideration (ie the sales-based royalty) should be allocated entirely to the performance obligation to grant the franchise licence.

Application guidance: licensing

- IE294 The entity assesses, in accordance with paragraph B58 of IFRS 15, the nature of the entity's promise to grant the franchise licence. The entity concludes that the criteria in paragraph B58 of IFRS 15 are met and the nature of the entity's promise is to provide access to the entity's intellectual property in its current form throughout the licence period. This is because:
- (a) the entity concludes that the customer would reasonably expect that the entity will undertake activities that will significantly affect the intellectual property to which the customer has rights. The ability of the customer to obtain benefit from the intellectual property to which the customer has rights is substantially derived from, or dependent upon, the expected activities of the entity. This is on the basis of the entity's customary business practice to undertake activities such as analysing consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns and operational efficiencies. In addition, the entity observes that because part of its compensation is dependent on the success of the franchisee (as evidenced through the sales-based royalty), the entity has a shared economic interest with the customer that indicates that the customer will expect the entity to undertake those activities to maximise earnings.
 - (b) the entity also observes that the franchise licence requires the customer to implement any changes that result from those activities and thus exposes the customer to any positive or negative effects of those activities.
 - (c) the entity also observes that even though the customer may benefit from the activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.
- IE295 Because the criteria in paragraph B58 of IFRS 15 are met, the entity concludes that the promise to transfer the licence is a performance obligation satisfied over time in accordance with paragraph 35(a) of IFRS 15.
- IE296 The entity also concludes that because the consideration that is in the form of a sales-based royalty relates specifically to the franchise licence (see paragraph B63A), the entity applies paragraph B63 of IFRS 15. After the transfer of the franchise licence, the entity recognises revenue as and when the customer's sales occur because the entity concludes that this reasonably depicts the entity's progress towards complete satisfaction of the franchise licence performance obligation.

Example 58—Access to intellectual property

- IE297 An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines. The contract requires the customer to use the latest images of the characters.
- IE298 In exchange for granting the licence, the entity receives a fixed payment of CU1 million in each year of the four-year term.
- IE299 In accordance with paragraph 27 of IFRS 15, the entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity concludes that it has no other performance obligations other than the promise to grant a licence. That is, the additional activities associated with the licence do not directly transfer a good or service to the customer because they are part of the entity's promise to grant a licence.
- IE300 The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph B58 of IFRS 15. In assessing the criteria the entity considers the following:

- (a) the customer reasonably expects (arising from the entity's customary business practices) that the entity will undertake activities that will significantly affect the intellectual property to which the customer has rights (ie the characters). This is because the entity's activities (ie development of the characters) change the form of the intellectual property to which the customer has rights. In addition, the ability of the customer to obtain benefit from the intellectual property to which the customer has rights is substantially derived from, or dependent upon, the entity's ongoing activities (ie the publishing of the comic strip).
 - (b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities because the contract requires the customer to use the latest characters.
 - (c) even though the customer may benefit from those activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.
- IE301 Consequently, the entity concludes that the criteria in paragraph B58 of IFRS 15 are met and that the nature of the entity's promise to transfer the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (ie the criterion in paragraph 35(a) of IFRS 15 is met).
- IE302 The entity applies paragraphs 39–45 of IFRS 15 to identify the method that best depicts its performance in the licence. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress towards complete satisfaction of the performance obligation.

Example 59—Right to use intellectual property

- IE303 An entity, a music record label, licenses to a customer a 1975 recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio and online advertisements for two years in Country A. In exchange for providing the licence, the entity receives fixed consideration of CU10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is non-cancellable.
- IE304 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity concludes that its only performance obligation is to grant the licence. The entity determines that the term of the licence (two years), its geographical scope (the customer's right to use the recording only in Country A), and the defined permitted use for the recording (in commercials) are all attributes of the promised licence in the contract.
- IE305 In accordance with paragraph B58 of IFRS 15, the entity assesses the nature of the entity's promise to grant the licence. The entity does not have any contractual or implied obligations to change the licensed recording. The licensed recording has significant stand-alone functionality (ie the ability to be played) and, therefore, the ability of the customer to obtain the benefits of the recording is not substantially derived from the entity's ongoing activities. The entity therefore determines that the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the licensed recording (ie the criterion in paragraph B58(a) is not met). Consequently, the entity concludes that the nature of its promise in transferring the licence is to provide the customer with a right to use the entity's intellectual property as it exists at the point in time that it is granted. Therefore, the promise to grant the licence is a performance obligation satisfied at a point in time. The entity recognises all of the revenue at the point in time when the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licensed intellectual property.

- IE306 Because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are non-cancellable), the entity considers the requirements in paragraphs 60–65 of IFRS 15 to determine whether a significant financing component exists.

Example 60—Access to intellectual property

- IE307 An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to (a) provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week screening period; and (b) sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week screening period. In exchange for providing the licence and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (ie variable consideration in the form of a sales-based royalty).
- IE308 The entity concludes that the licence to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the related promotional goods or services. The entity recognises revenue from the sales-based royalty, the only consideration to which the entity is entitled under the contract, wholly in accordance with paragraph B63. If the licence, the memorabilia and the advertising activities are separate performance obligations, the entity would allocate the sales-based royalty to each performance obligation.

Example 61—Access to intellectual property

- IE309 An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs and towels for one year. In exchange for providing the licence, the entity will receive fixed consideration of CU2 million and a royalty of five per cent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.
- IE310 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity concludes that its only performance obligation is to transfer the licence. The additional activities associated with the licence (ie continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer because they are part of the entity's promise to grant the licence.
- IE311 The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph B58 of IFRS 15. In assessing the criteria the entity considers the following:
- (a) the entity concludes that the customer would reasonably expect that the entity will undertake activities that will significantly affect the intellectual property (ie the team name and logo) to which the customer has rights. This is on the basis of the entity's customary business practice to undertake activities that support and maintain the value of the name and logo such as continuing to play and providing a competitive team. The entity determines that the ability of the customer to obtain benefit from the name and logo is substantially derived from, or dependent upon, the expected activities of the entity. In addition, the entity observes that because some of its consideration is dependent on the success of the customer (through the sales-based royalty), the entity has a shared economic interest with the customer, which indicates that the customer will expect the entity to undertake those activities to maximise earnings.
 - (b) the entity observes that the rights granted by the licence (ie the use of the team's name and logo) directly expose the customer to any positive or negative effects of the entity's activities.

- (c) the entity also observes that even though the customer may benefit from the activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.
- IE312 The entity concludes that the criteria in paragraph B58 of IFRS 15 are met and the nature of the entity's promise to grant the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (ie the criterion in paragraph 35(a) of IFRS 15 is met).
- IE313 The entity then applies paragraphs 39–45 of IFRS 15 to determine a measure of progress that will depict the entity's performance. For the consideration that is in the form of a sales-based royalty, paragraph B63 of IFRS 15 applies because the sales-based royalty relates solely to the licence, which is the only performance obligation in the contract. The entity concludes that recognition of the CU2 million fixed consideration as revenue rateably over time plus recognition of the royalty as revenue as and when the customer's sales of items using the team name or logo occur reasonably depicts the entity's progress towards complete satisfaction of the licence performance obligation.

Repurchase agreements

- IE314 Example 62 illustrates the requirements in paragraphs B64–B76 of IFRS 15 on repurchase agreements.

Example 62—Repurchase agreements

- IE315 An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X7 for CU1 million.

Case A—Call option: financing

- IE316 The contract includes a call option that gives the entity the right to repurchase the asset for CU1.1 million on or before 31 December 20X7.
- IE317 Control of the asset does not transfer to the customer on 31 December 20X7 because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph B66(b) of IFRS 15, the entity accounts for the transaction as a financing arrangement, because the exercise price is more than the original selling price. In accordance with paragraph B68 of IFRS 15, the entity does not derecognise the asset and instead recognises the cash received as a financial liability. The entity also recognises interest expense for the difference between the exercise price (CU1.1 million) and the cash received (CU1 million), which increases the liability.

- IE318 On 31 December 20X7, the option lapses unexercised; therefore, the entity derecognises the liability and recognises revenue of CU1.1 million.

Case B—Put option: lease

- IE319 Instead of having a call option, the contract includes a put option that obliges the entity to repurchase the asset at the customer's request for CU900,000 on or before 31 December 20X7. The market value is expected to be CU750,000 on 31 December 20X7.
- IE320 At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs B70–B76 of IFRS 15). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly

exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

- IE321 In accordance with paragraphs B70–B71 of IFRS 15, the entity accounts for the transaction as a lease in accordance with IAS 17 *Leases*.

Bill-and-hold arrangements

- IE322 Example 63 illustrates the requirements in paragraphs B79–B82 of IFRS 15 on bill-and-hold arrangements.

Example 63—Bill-and-hold arrangement

- IE323 An entity enters into a contract with a customer on 1 January 20X8 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.
- IE324 Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31 December 20X9, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.
- IE325 The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control transfers to the customer.
- IE326 Control of the machine transfers to the customer on 31 December 20X9 when the customer takes physical possession. The entity assesses the indicators in paragraph 38 of IFRS 15 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in paragraph B81 of IFRS 15 are met, which is necessary for the entity to recognise revenue in a bill-and-hold arrangement. The entity recognises revenue for the spare parts on 31 December 20X9 when control transfers to the customer.
- IE327 The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 60–65 of IFRS 15.

Appendix

Amendments to the guidance on other Standards

The appendix contains amendments to guidance on other IFRSs that are necessary in order to ensure consistency with IFRS 15 and the related amendments to other IFRSs.

The amendments contained in this appendix when this Standard was issued in 2014 have been incorporated into the relevant Standards.

Effective for annual periods
beginning on or after 1 January 2005

HK(IFRIC) Interpretation 2

Members' Shares in Co-operative Entities and Similar Instruments



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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APPENDICES**Examples of application of the conclusions****BASIS FOR CONCLUSIONS**

HK(IFRIC) Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* (HK(IFRIC)-Int 2) is set out in paragraphs 1–197 and the Appendices. HK(IFRIC)-Int 2 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKFRS 9 *Financial Instruments*
- HKFRS 13 *Fair Value Measurement*
- HKAS 32 *Financial Instruments: Disclosure and Presentation*^{*}
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~

Background

- 1 Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'.
- 2 HKAS 32 establishes principles for the classification of financial instruments as financial liabilities or equity. In particular, those principles apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. The application of those principles to members' shares in co-operative entities and similar instruments is difficult. Guidance has been requested on understanding how the principles in HKAS 32 apply to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or equity.

Scope

- 3 This Interpretation applies to financial instruments within the scope of HKAS 32, including financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity. This Interpretation does not apply to financial instruments that will or may be settled in the entity's own equity instruments.

Issue

- 4 Many financial instruments, including members' shares, have characteristics of equity, including voting rights and rights to participate in dividend distributions. Some financial instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. How should those redemption terms be evaluated in determining whether the financial instruments should be classified as liabilities or equity?

Conclusions

- 5 The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.
- 6 Members' shares that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 7 and 8 is present or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.
- 7 Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

^{*} HKAS 32 was amended as HKAS 32 *Financial Instruments: Presentation* for annual periods beginning on or after 1 January 2007. In June 2008 the HKICPA amended HKAS 32 by requiring instruments to be classified as equity if those instruments have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32.

- 8 Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.
- 9 An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7 or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.
- 10 At initial recognition, the entity shall measure its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law discounted from the first date that the amount could be required to be paid (see example 3).
- 11 As required by paragraph 35 of HKAS 32, distributions to holders of equity instruments are recognised directly in equity. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.
- 12 The Appendix, which is an integral part of the conclusions, provides examples of the application of these conclusions.

Disclosure

- 13 When a change in the redemption prohibition leads to a transfer between financial liabilities and equity, the entity shall disclose separately the amount, timing and reason for the transfer.

Effective date

- 14 The effective date and transition requirements of this Interpretation are the same as those for HKAS 32. An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2005. If an entity applies this Interpretation for a period beginning before 1 January 2005, it shall disclose that fact. This Interpretation shall be applied retrospectively.
- 14A An entity shall apply the amendments in paragraphs 6, 9, A1 and A12 for annual periods beginning on or after 1 January 2009. If an entity applies *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1), issued in June 2008, for an earlier period, the amendments in paragraphs 6, 9, A1 and A12 shall be applied for that earlier period.
- 15 ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~[Deleted]
- 16 HKFRS 13, issued in June 2011, amended paragraph A8. An entity shall apply that amendment when it applies HKFRS 13.
- 17 *Annual Improvements 2009-2011 Cycle*, issued in June 2012, amended paragraph 11. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. If an entity applies that amendment to HKAS 32 as a part of the *Annual Improvements 2009-2011 Cycle* (issued in June 2012) for an earlier period, the amendment in paragraph 11 shall be applied for that earlier period.
- 18 [Deleted]
- 19 HKFRS 9, as issued in September 2014, amended paragraphs A8 and A10 and deleted paragraphs 15 and 18. An entity shall apply those amendments when it applies HKFRS 9.

Appendix

Examples of application of the conclusions

This appendix is an integral part of the Interpretation.

- A1 This appendix sets out seven examples of the application of the HK(IFRIC)-Int conclusions. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instrument does not have all the features or does not meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32.

Unconditional right to refuse redemption (paragraph 7)

Example 1

Facts

- A2 The entity's charter states that redemptions are made at the sole discretion of the entity. The charter does not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board has the right to do so.

Classification

- A3 The entity has the unconditional right to refuse redemption and the members' shares are equity. HKAS 32 establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph AG26 of HKAS 32 states:

When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

- (a) a history of making distributions;
- (b) an intention to make distributions in the future;
- (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
- (d) the amount of the issuer's reserves;
- (e) an issuer's expectation of a profit or loss for a period; or
- (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Example 2

Facts

- A4 The entity's charter states that redemptions are made at the sole discretion of the entity. However, the charter further states that approval of a redemption request is automatic unless the entity is unable to make payments without violating local regulations regarding liquidity or reserves.

Classification

- A5 The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in HKAS 32, result in the classification of the financial instrument as equity. Paragraph AG25 of HKAS 32 states:

Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]

Prohibitions against redemption (paragraphs 8 and 9)

Example 3**Facts**

- A6 A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

- (a) 1 January 20X1 100,000 shares at CU10 each (CU1,000,000);
- (b) 1 January 20X2 100,000 shares at CU20 each (a further CU2,000,000, so that the total for shares issued is CU3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

- A7 The entity's charter states that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20X2 the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20X3 the entity amends its governing charter and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing charter is amended

- A8 Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity measures the fair value of such financial liabilities ~~as required by~~ in accordance with paragraph 47 of HKFRS 13, which states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand ...'. Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.
- A9 On 1 January 20X1 the maximum amount payable under the redemption provisions is 20,000 shares at CU10 each and accordingly the entity classifies CU200,000 as financial liability and CU800,000 as equity. However, on 1 January 20X2 because of the new issue of shares at CU20, the maximum amount payable under the redemption provisions increases to 40,000 shares at CU20 each. The issue of additional shares at CU20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at CU20, or CU800,000. This requires recognition of an additional liability of CU600,000. In this example no gain or loss is recognised. Accordingly the entity now classifies CU800,000 as financial liabilities and CU2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20X1 and 31 December 20X2.

After the governing charter is amended

- A10 Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on 1 January 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph ~~49 of HKAS 39~~47 of HKFRS 13. It therefore transfers on 1 January 20X3 from equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity. In this example the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

- A11 Local law governing the operations of co-operatives, or the terms of the entity's governing charter, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is CU1,000,000. At the end of the reporting period the balance of paid-in capital is CU900,000.

Classification

- A12 In this case, CU750,000 would be classified as equity and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 18(b) of HKAS 32 states in part:

...a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D.

- A13 The redemption prohibition described in this example is different from the restrictions described in paragraphs 19 and AG25 of HKAS 32. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, ie they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (eg given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-in capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

- A14 The facts of this example are as stated in example 4. In addition, at the end of the reporting period, liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the end of the reporting period is that the entity cannot pay more than CU50,000 to redeem the members' shares.

Classification

- A15 As in example 4, the entity classifies CU750,000 as equity and CU150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 19 and AG25 of HKAS 32 apply in this case.

Example 6**Facts**

- A16 The entity's governing charter prohibits it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been CU12,000 and no member's shares have been redeemed.

Classification

- A17 The entity classifies CU12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7**Facts**

- A18 The entity is a co-operative bank. Local law governing the operations of co-operative banks state that at least 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the regulations to include members' share accounts) has to be in the form of members' paid-in capital. The effect of the regulation is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On 31 December 20X1 the entity has total outstanding liabilities of CU200,000, of which CU125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the entity's charter.

Classification

- A19 In this example members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 19 and AG25 of HKAS 32. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, ie they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (CU125,000) if it repaid all of its other liabilities (CU75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, ie the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IFRIC 2.

HK(IFRIC) Interpretation 2 is based on IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments*. In approving HK(IFRIC) Interpretation 2, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 2. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 2 and IFRIC Interpretation 2. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 2 referred to below generally correspond with those in HK(IFRIC) Interpretation 2.

Introduction

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

- BC2 In September 2001, the Standing Interpretations Committee instituted by the former International Accounting Standards Committee (IASC) published Draft Interpretation SIC D-34 *Financial Instruments - Instruments or Rights Redeemable by the Holder*. The Draft Interpretation stated: 'The issuer of a Puttable Instrument should classify the entire instrument as a liability.'
- BC3 In 2001 the International Accounting Standards Board (IASB) began operations in succession to IASC. The IASB's initial agenda included a project to make limited amendments to the financial instruments standards issued by IASC. The IASB decided to incorporate the consensus from Draft Interpretation D-34 as part of those amendments. In June 2002 the IASB published an exposure draft of amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* that incorporated the proposed consensus from Draft Interpretation D-34.
- BC4 In their responses to the Exposure Draft and in their participation in public round-table discussions held in March 2003, representatives of co-operative banks raised questions about the application of the principles in IAS 32 to members' shares. This was followed by a series of meetings between IASB members and staff and representatives of the European Association of Co-operative Banks. After considering questions raised by the bank group, the IASB concluded that the principles articulated in IAS 32 should not be modified, but that there were questions about the application of those principles to co-operative entities that should be considered by the IFRIC.
- BC5 In considering the application of IAS 32 to co-operative entities, the IFRIC recognised that a variety of entities operate as co-operatives and these entities have a variety of capital structures. The IFRIC decided that its proposed Interpretation should address some features that exist in a number of co-operatives. However, the IFRIC noted that its conclusions and the examples in the Interpretation are not limited to the specific characteristics of members' shares in European co-operative banks.

Basis for consensus

- BC6 Paragraph 15 of IAS 32 states:
- The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the *substance of the contractual arrangement* and the definitions of a financial liability, a financial asset and an equity instrument. [Emphasis added]
- BC7 In many jurisdictions, local law or regulations state that members' shares are equity of the entity. However, paragraph 17 of IAS 32 states:
- With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a critical feature in differentiating a financial liability from an equity instrument is *the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer*. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party. [Emphasis added]

- BC8 Paragraphs cited in the examples in the Appendix and in the paragraphs above show that, under IAS 32, the terms of the contractual agreement govern the classification of a financial instrument as a financial liability or equity. If the terms of an instrument create an unconditional obligation to transfer cash or another financial asset, circumstances that might restrict an entity's ability to make the transfer when due do not alter the classification as a financial liability. If the terms of the instrument give the entity an unconditional right to avoid delivering cash or another financial asset, the instrument is classified as equity. This is true even if other factors make it likely that the entity will continue to distribute dividends or make or other payments. In view of those principles, the IFRIC decided to focus on circumstances that would indicate that the entity has the unconditional right to avoid making payments to a member who has requested that his or her shares be redeemed.
- BC9 The IFRIC identified two situations in which a co-operative entity has an unconditional right to avoid the transfer of cash or another financial asset. The IFRIC acknowledges that there may be other situations that may raise questions about the application of IAS 32 to members' shares. However, it understands that the two situations are often present in the contractual and other conditions surrounding members' shares and that interpretation of those two situations would eliminate many of the questions that may arise in practice.
- BC10 The IFRIC also noted that an entity assesses whether it has an unconditional right to avoid the transfer of cash or another financial asset on the basis of local laws, regulations and its governing charter in effect at the date of classification. This is because it is local laws, regulations and the governing charter in effect at the classification date, together with the terms contained in the instrument's documentation that constitute the terms and conditions of the instrument at that date. Accordingly, an entity does not take into account expected future amendments to local law, regulation or its governing charter.

The right to refuse redemption (paragraph 7)

- BC11 An entity may have the unconditional right to refuse redemption of a member's shares. If such a right exists, the entity does not have the obligation to transfer cash or another financial asset that IAS 32 identifies as a critical characteristic of a financial liability.
- BC12 The IFRIC considered whether the entity's history of making redemptions should be considered in deciding whether the entity's right to refuse requests is, in fact, unconditional. The IFRIC observed that a history of making redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26 (cited in paragraph A3), a holder's expectations about dividends do not cause a preferred share to be classified as a financial liability.

Prohibitions against redemption (paragraphs 8 and 9)

- BC13 An entity may be prohibited by law or its governing charter from redeeming members' shares if doing so would cause the number of members' shares, or the amount of paid-in capital from members' shares, to fall below a specified level. While each individual share might be puttable, a portion of the total shares outstanding is not.
- BC14 The IFRIC concluded that conditions limiting an entity's ability to redeem members' shares must be evaluated sequentially. Unconditional prohibitions like those noted in paragraph 8 of the consensus prevent the entity from *incurring a liability* for redemption of all or some of the members' shares, regardless of whether it would otherwise be able to satisfy that financial liability. This contrasts with conditional prohibitions that prevent payments being made only if specified conditions—such as liquidity constraints—are met. Unconditional prohibitions prevent a liability from coming into existence, whereas the conditional prohibitions may only defer the payment of a liability already incurred. Following this analysis, an unconditional prohibition affects classification when an instrument subject to the prohibition is issued or when the prohibition is enacted or added to the entity's governing charter. In contrast, conditional restrictions such as those described in paragraphs 19 and AG25 of IAS 32 do not result in equity classification.

- BC15 The IFRIC discussed whether the requirements in IAS 32 can be applied to the classification of members' shares as a whole subject to a partial redemption prohibition. IAS 32 refers to 'a financial instrument', 'a financial liability' and 'an equity instrument'. It does not refer to groups or portfolios of instruments. In view of this the IFRIC considered whether it could apply the requirements in IAS 32 to the classification of members' shares subject to partial redemption prohibitions. The application of IAS 32 to a prohibition against redeeming some portion of members' shares (eg 500,000 shares of an entity with 1,000,000 shares outstanding) is unclear.
- BC16 The IFRIC noted that classifying a group of members' shares using the individual instrument approach could lead to misapplication of the principle of 'substance of the contract' in IAS 32. The IFRIC also noted that paragraph 23 of IAS 32 requires an entity that has entered into an agreement to purchase its own equity instruments to recognise a financial liability for the present value of the redemption amount (eg for the present value of the forward repurchase price, option exercise price or other redemption amount) even though the shares subject to the repurchase agreement are not individually identified. Accordingly, the IFRIC decided that for purposes of classification there are instances when IAS 32 does not require the individual instrument approach.
- BC17 In many situations, looking at either individual instruments or all of the instruments governed by a particular contract would result in the same classification as financial liability or equity under IAS 32. Thus, if an entity is prohibited from redeeming any of its members' shares, the shares are not puttable and are equity. On the other hand, if there is no prohibition on redemption and no other conditions apply, members' shares are puttable and the shares are financial liabilities. However, in the case of partial prohibitions against redemption, the classification of members' shares governed by the same charter will differ, depending on whether such a classification is based on individual members' shares or the group of members' shares as a whole. For example, consider an entity with a partial prohibition that prevents it from redeeming 99 per cent of the highest number of members' shares ever outstanding. The classification based on individual shares considers each share to be potentially puttable and therefore a financial liability. This is different from the classification based on all of the members' shares. While each member's share may be redeemable individually, 99 per cent of the highest number of shares ever outstanding is not redeemable in any circumstances other than liquidation of the entity and therefore is equity.

Measurement on initial recognition (paragraph 10)

- BC18 The IFRIC noted that when the financial liability for the redemption of members' shares that are redeemable on demand is initially recognised, the financial liability is measured at fair value in accordance with paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement*.^{*} Paragraph 49 states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid'. Accordingly, the IFRIC decided that the fair value of the financial liability for redemption of members' shares redeemable on demand is the maximum amount payable under the redemption provisions of its governing charter or applicable law. The IFRIC also considered situations in which the number of members' shares or the amount of paid-in capital subject to prohibition against redemption may change. The IFRIC concluded that a change in the level of a prohibition against redemption should lead to a transfer between financial liabilities and equity.

Subsequent measurement

- BC19 Some respondents requested additional guidance on subsequent measurement of the liability for redemption of members' shares. The IFRIC noted that the focus of this Interpretation was on clarifying the classification of financial instruments rather than their subsequent measurement. Also, the IASB has on its agenda a project to address the accounting for financial instruments (including members' shares) that are redeemable at a pro rata share of the fair value of the residual interest in the entity issuing the financial instrument. The IASB will consider certain measurement issues in this project. The IFRIC was also informed that the majority of members' shares in co-operative entities are not redeemable at a pro rata share of the fair value of the residual interest in the co-operative entity thereby obviating the more complex measurement issues. In view of the above, the IFRIC decided not to provide additional guidance on measurement in the Interpretation.

* IFRS 9 *Financial Instruments* replaced IAS 39. Paragraph 49 of IAS 39 was ultimately relocated to paragraph 47 of IFRS 13 *Fair Value Measurement*. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

Presentation

- BC20 The IFRIC noted that entities whose members' shares are not equity could use the presentation formats included in paragraphs IE32 and IE33 of the Illustrative Examples with IAS 32.

Alternatives considered

- BC21 The IFRIC considered suggestions that:
- (a) members' shares should be classified as equity until a member has requested redemption. That member's share would then be classified as a financial liability and this treatment would be consistent with local laws. Some commentators believe this is a more straightforward approach to classification.
 - (b) the classification of members' shares should incorporate the probability that members will request redemption. Those who suggest this view observe that experience shows this probability to be small, usually within 1-5 per cent, for some types of co-operative. They see no basis for classifying 100 per cent of the members' shares as liabilities on the basis of the behaviour of 1 per cent.
- BC22 The IFRIC did not accept those views. Under IAS 32, the classification of an instrument as financial liability or equity is based on the 'substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.' In paragraph BC7 of the Basis for Conclusions on IAS 32, the IASB observed:

Although the legal form of such financial instruments often includes a right to the residual interest in the assets of an entity available to holders of such instruments, the inclusion of an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. The classification as a financial liability is independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity.

- BC23 The IFRIC also observed that an approach similar to that in paragraph BC21(a) is advocated in the Dissenting Opinion of one Board member on IAS 32. As the IASB did not adopt that approach its adoption here would require an amendment to IAS 32.

Transition and effective date (paragraph 14)

- BC24 The IFRIC considered whether its Interpretation should have the same transition and effective date as IAS 32, or whether a later effective date should apply with an exemption from IAS 32 for members' shares in the interim. Some co-operatives may wish to amend their governing charter in order to continue their existing practice under national accounting requirements of classifying members' shares as equity. Such amendments usually require a general meeting of members and holding a meeting may not be possible before the effective date of IAS 32.
- BC25 After considering a number of alternatives, the IFRIC decided against any exemption from the transition requirements and effective date in IAS 32. In reaching this conclusion, the IFRIC noted that it was requested to provide guidance on the application of IAS 32 when it is first adopted by co-operative entities, ie from 1 January 2005. Also, the vast majority of those who commented on the draft Interpretation did not object to the proposed effective date of 1 January 2005. Finally, the IFRIC observed that classifying members' shares as financial liabilities before the date that the terms of these shares are amended will affect only 2005 financial statements, as first-time adopters are not required to apply IAS 32 to earlier periods. As a result, any effect of the Interpretation on first-time adopters is expected to be limited. Furthermore, the IFRIC noted that regulators are familiar with the accounting issues involved. A co-operative entity may be required to present members' shares as a liability until the governing charter is amended. The IFRIC understands that such amendments, if adopted, could be in place by mid-2005. Accordingly, the IFRIC decided that the effective date for the Interpretation would be annual periods beginning on or after 1 January 2005.

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 4

Determining whether an Arrangement contains a Lease



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- BC14 The IFRIC considered whether the scope of the Interpretation might overlap with IAS 39 *Financial Instruments: Recognition and Measurement*.^{*} In particular it noted the view that an arrangement for output might meet the definition of a derivative under IAS 39 but also be determined to contain a lease under this Interpretation. The IFRIC concluded that there should not be an overlap because an arrangement for output that is a derivative would not meet the criteria in paragraphs 6-9 of the Interpretation. In particular, the IFRIC noted that such an arrangement would be for a product with a quoted market price available in an active market and would therefore be unlikely to depend upon the use of a specifically identified asset.
- BC14A The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 12, which was developed from draft Interpretations D12-D14. In particular it noted the views expressed by some respondents to the proposals that the contractual terms of some public-to-private service concession arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion of D12-D14. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. The IFRIC therefore amended IFRIC 4 to specify that if a public-to-private service concession arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

Consensus (paragraphs 6-15)

Criteria for determining whether an arrangement contains a lease (paragraphs 6-9)

- BC15 In D3 the IFRIC proposed that three criteria would all need to be satisfied for an arrangement to be, or contain, a lease:
- (a) The arrangement depends upon a specific item or items (the item). The item need not be explicitly identified by the contractual provisions of the arrangement. Rather it may be implicitly identified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative items.
 - (b) The arrangement conveys a right to use the item for a specific period of time such that the purchaser is able to exclude others from using the item.
 - (c) Payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item.
- BC16 D3 also proposed that arrangements in which there is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output produced by an item would meet the second of the criteria above.
- BC17 In its Basis for Conclusions on D3, the IFRIC drew attention to the similarities between its Interpretation and Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease* published by the US Emerging Issues Task Force (EITF) in May 2003. The IFRIC concluded that '[a]lthough the wording of Issue 01-8 and the draft Interpretation differ, ...a similar assessment of whether an arrangement contains a lease is likely under both interpretations.'
- BC18 Some respondents disagreed with the IFRIC's conclusion and suggested that the differences between the two interpretations were, in fact, significant. The IFRIC, however, maintained its original conclusion. In particular, it noted that both it and the EITF had concluded that a right of use can be conveyed in arrangements in which purchasers have rights to acquire the output that will be produced by an asset, regardless of any right or ability physically to operate or control access to that asset. Accordingly, many take-or-pay (and similar contracts) would have been similarly assessed under the two interpretations.
- BC19 Nonetheless, the IFRIC agreed that some arrangements would be regarded as leases under Issue 01-8 but not under D3. The IFRIC concluded that there were two main reasons for this. First, the effect of the third criterion in D3 ('payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item') was that a purchaser would always be required to assume some pricing risk in an arrangement for there to be a lease. This is not the case under Issue 01-8. Secondly, the second criterion in D3 ('the arrangement conveys a right to use the item ...such that the purchaser is able to exclude others

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 5

Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds



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APPENDIX

Amendment to HKAS 39 *Financial Instruments: Recognition and Measurement*

BASIS FOR CONCLUSIONS

HK(IFRIC) Interpretation 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* (HK(IFRIC)-Int 5) is set out in paragraphs 1-15 and the Appendix. HK(IFRIC)-Int 5 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 5

Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

References

- HKFRS 9 *Financial Instruments*
- HKFRS 10 *Consolidated Financial Statements*
- HKFRS 11 *Joint Arrangements*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 28 *Investments in Associates and Joint Ventures*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~

Background

- 1 The purpose of decommissioning, restoration and environmental rehabilitation funds, hereafter referred to as 'decommissioning funds' or 'funds', is to segregate assets to fund some or all of the costs of decommissioning plant (such as a nuclear plant) or certain equipment (such as cars), or in undertaking environmental rehabilitation (such as rectifying pollution of water or restoring mined land), together referred to as 'decommissioning'.
- 2 Contributions to these funds may be voluntary or required by regulation or law. The funds may have one of the following structures:
 - (a) funds that are established by a single contributor to fund its own decommissioning obligations, whether for a particular site, or for a number of geographically dispersed sites.
 - (b) funds that are established with multiple contributors to fund their individual or joint decommissioning obligations, when contributors are entitled to reimbursement for decommissioning expenses to the extent of their contributions plus any actual earnings on those contributions less their share of the costs of administering the fund. Contributors may have an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor.
 - (c) funds that are established with multiple contributors to fund their individual or joint decommissioning obligations when the required level of contributions is based on the current activity of a contributor and the benefit obtained by that contributor is based on its past activity. In such cases there is a potential mismatch in the amount of contributions made by a contributor (based on current activity) and the value realisable from the fund (based on past activity).

- 3 Such funds generally have the following features:
- (a) the fund is separately administered by independent trustees.
 - (b) entities (contributors) make contributions to the fund, which are invested in a range of assets that may include both debt and equity investments, and are available to help pay the contributors' decommissioning costs. The trustees determine how contributions are invested, within the constraints set by the fund's governing documents and any applicable legislation or other regulations.
 - (c) the contributors retain the obligation to pay decommissioning costs. However, contributors are able to obtain reimbursement of decommissioning costs from the fund up to the lower of the decommissioning costs incurred and the contributor's share of assets of the fund.
 - (d) the contributors may have restricted access or no access to any surplus of assets of the fund over those used to meet eligible decommissioning costs.

Scope

- 4 This Interpretation applies to accounting in the financial statements of a contributor for interests arising from decommissioning funds that have both of the following features:
- (a) the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity); and
 - (b) a contributor's right to access the assets is restricted.
- 5 A residual interest in a fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of ~~HKAS 39~~ HKFRS 9 and is not within the scope of this Interpretation.

Issues

- 6 The issues addressed in this Interpretation are:
- (a) how should a contributor account for its interest in a fund?
 - (b) when a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor, how should that obligation be accounted for?

Conclusions

Accounting for an interest in a fund

- 7 The contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay.
- 8 The contributor shall determine whether it has control or joint control of, or significant influence over, the fund by reference to HKFRS 10, HKFRS 11 and HKAS 28. If it does, the contributor shall account for its interest in the fund in accordance with those Standards.
- 9 If a contributor does not have control or joint control of, or significant influence over, the fund, the contributor shall recognise the right to receive reimbursement from the fund as a reimbursement in accordance with HKAS 37. This reimbursement shall be measured at the lower of:
- (a) the amount of the decommissioning obligation recognised; and
 - (b) the contributor's share of the fair value of the net assets of the fund attributable to contributors.

Changes in the carrying value of the right to receive reimbursement other than contributions to and payments from the fund shall be recognised in profit or loss in the period in which these changes occur.

Accounting for obligations to make additional contributions

- 10 When a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, this obligation is a contingent liability that is within the scope of HKAS 37. The contributor shall recognise a liability only if it is probable that additional contributions will be made.

Disclosure

- 11 A contributor shall disclose the nature of its interest in a fund and any restrictions on access to the assets in the fund.
- 12 When a contributor has an obligation to make potential additional contributions that is not recognised as a liability (see paragraph 10), it shall make the disclosures required by paragraph 86 of HKAS 37.
- 13 When a contributor accounts for its interest in the fund in accordance with paragraph 9, it shall make the disclosures required by paragraph 85(c) of HKAS 37.

Effective date

- 14 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies this Interpretation to a period beginning before 1 January 2006, it shall disclose that fact.
- 14A ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.] [Deleted]~~
- 14B HKFRS 10 and HKFRS 11, issued in June 2011, amended paragraphs 8 and 9. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 14C [Deleted]
- 14D HKFRS 9, as issued in September 2014, amended paragraph 5 and deleted paragraphs 14A and 14C. An entity shall apply those amendments when it applies HKFRS 9.

Transition

- 15 Changes in accounting policies shall be accounted for in accordance with the requirements of HKAS 8.

Appendix

Amendment to HKAS 39 *Financial Instruments: Recognition and Measurement*

The amendment in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies this Interpretation for an earlier period, the amendment shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standards.

Basis for Conclusions on IFRIC Interpretation 5

This Basis for Conclusions accompanies, but is not part of, IFRIC 5.

The original text has been marked up to reflect the revision of HKAS 1 Presentation of Financial Statements in 2007; new text is underlined and deleted text is struck through.

HK(IFRIC) Interpretation 5 is based on IFRIC Interpretation 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*. In approving HK(IFRIC) Interpretation 5, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 5. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 5 and IFRIC Interpretation 5. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 5 referred to below generally correspond with those in HK(IFRIC) Interpretation 5.

Introduction

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

- BC2 The IFRIC was informed that an increasing number of entities with decommissioning obligations are contributing to a separate fund established to help fund those obligations. The IFRIC was also informed that questions have arisen in practice over the accounting treatment of interests in such funds and that there is a risk that divergent practices may develop. The IFRIC therefore concluded that it should provide guidance to assist in answering the questions in paragraph 6, in particular on the accounting for the asset of the right to receive reimbursement from a fund. On the issue of whether the fund should be consolidated or equity accounted, the IFRIC concluded that the normal requirements of IAS 27 *Consolidated and Separate Financial Statements*, SIC-12 *Consolidation—Special Purpose Entities*, IAS 28 *Investments in Associates*¹ or IAS 31 *Interests in Joint Ventures*² apply and that there is no need for interpretative guidance³. The IFRIC published its proposed Interpretation on 15 January 2004 as D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*.
- BC3 Paragraphs 1-3 describe ways in which entities might arrange to fund their decommissioning obligations. Those that are within the scope of the Interpretation are specified in paragraphs 4-6.

Scope (paragraphs 4 and 5)

- BC4 D4 did not precisely define the scope because the IFRIC believed that the large variety of schemes in operation would make any definition inappropriate. However, some respondents to D4 disagreed and commented that the absence of any definition made it unclear when the Interpretation should be applied. As a result, the IFRIC has specified the scope by identifying the features that make an arrangement a decommissioning fund. It has also described the different types of fund and the features that may (or may not) be present.
- BC5 The IFRIC considered whether it should issue a wider Interpretation that addresses similar forms of reimbursement, or whether it should prohibit the application of the Interpretation to other situations by analogy. The IFRIC rejected any widening of the scope, deciding instead to concentrate on the matter referred to it. The IFRIC also decided that there was no reason to prohibit the application of the Interpretation to other situations by analogy and thus the hierarchy of criteria in paragraphs 7-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply, resulting in similar accounting for reimbursements under arrangements that are not decommissioning funds, but have similar features.
- BC6 The IFRIC considered comments from respondents that a contributor may have an interest in the fund that extends beyond its right to reimbursement. In response, the IFRIC added clarification that a residual interest in a fund, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.⁴

¹ In May 2011, the Board amended IAS 28 and changed its title to *Investments in Associates and Joint Ventures*.

² IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

³ The consolidation requirements in IAS 27 and SIC-12 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011.

⁴ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Basis for consensus

Accounting for an interest in a fund (paragraphs 7-9)

- BC7 The IFRIC concluded that the contributor should recognise a liability unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. This is because the contributor remains liable for the decommissioning costs. Additionally, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides that:
- (a) when an entity remains liable for expenditure, a provision should be recognised even where reimbursement is available; and
 - (b) if the reimbursement is virtually certain to be received when the obligation is settled, then it should be treated as a separate asset.
- BC8 In concluding that the contributor should recognise separately its liability to pay decommissioning costs and its interest in the fund, the IFRIC also noted the following:
- (a) There is no legally enforceable right to set off the rights under the decommissioning fund against the decommissioning liabilities. Also, given that the main objective is reimbursement, it is likely that settlement will not be net or simultaneous. Accordingly, treating these rights and liabilities as analogous to financial assets and financial liabilities would not result in offset because the offset criteria in IAS 32 *Financial Instruments: Disclosure and Presentation*⁵ are not met.
 - (b) Treating the decommissioning obligation as analogous to a financial liability would not result in derecognition through extinguishment. If the fund does not assume the obligation for decommissioning, the criteria in IAS 39⁶ for derecognition of financial liabilities through extinguishment are not met. At best, the fund acts like an in-substance defeasance that does not qualify for derecognition of the liability.
 - (c) It would not be appropriate to treat decommissioning funds as analogous to pension funds, which are presented net of the related liability. This is because, in allowing a net presentation for pension plans in IAS 19 *Employee Benefits*, the International Accounting Standards Board's predecessor organisation, IASC, stated that it believed the situation is 'unique to employee benefit plans and [it did] not intend to permit this net presentation for other liabilities if the conditions in IAS 32 and IAS 39⁶ are not met' (IAS 19, Basis for Conclusions paragraph 68I)⁷.
- BC9 As to the accounting for the contributor's interest in the fund, the IFRIC noted that some interests in funds would be within the scope of IAS 27, IAS 28, IAS 31⁸ or SIC-12. As noted in paragraph BC2, the IFRIC concluded that, in such cases, the normal requirements of those Standards would apply and there is no need for interpretative guidance.
- BC10 Otherwise, the IFRIC concluded that the contributor has an asset for its right to receive amounts from the fund.

The right to receive reimbursement from a fund and amendment to the scope of IAS 39⁵

- BC11 The IFRIC noted that under existing IFRSs, there are two forms of rights to reimbursement that would be accounted for differently:
- (a) A contractual right to receive reimbursement in the form of cash. This meets the definition of a financial asset and is within the scope of IAS 39. Such a financial asset would be classified as an available-for-sale financial asset⁹ (unless accounted for using the fair value option) because it does not meet the definitions of a financial asset held for trading, a held-to-maturity investment or a loan or receivable.¹⁰

⁵ In August 2005, IAS 32 has amended as IAS 32 *Financial Instruments: Presentation*.

⁶ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

⁷ Paragraph BC68I was renumbered as paragraph BC186 when IAS 19 was amended in 2011.

⁸ IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

⁹ IFRS 9 *Financial Instruments* eliminated the categories of available-for-sale and held-to-maturity financial assets

¹⁰ ~~An interest in a decommissioning fund would not meet the definition of held for trading because it is not acquired or incurred principally for the purpose of selling or repurchasing it in the near term, nor of a held-to-maturity investment because it does not have fixed or determinable maturity. In addition, an interest in a fund is excluded from the definition of loans and receivables in IAS 39 since it is 'an interest acquired in a pool of assets that are not loans and receivables'.~~

- (b) A right to reimbursement other than a contractual right to receive cash. This does not meet the definition of a financial asset and is within the scope of IAS 37.
- BC12 The IFRIC concluded that both these forms of reimbursement have economically identical effects. Therefore accounting for both forms in the same way would provide relevant and reliable information to a user of the financial statements. However, the IFRIC noted that this did not appear possible under existing IFRSs because some such rights are within the scope of IAS 39, and others are not. Therefore, it asked the Board to amend the scope of IAS 39 to exclude rights to reimbursement for expenditure required to settle:
- (a) a provision that has been recognised in accordance with IAS 37; and
- (b) obligations that had been originally recognised as provisions in accordance with IAS 37, but are no longer provisions because their timing or amount is no longer uncertain. An example of such a liability is one that was originally recognised as a provision because of uncertainty about the timing of the cash outflow, but subsequently becomes another type of liability because the timing is now certain.
- BC13 This amendment was approved by the Board and is set out in the Appendix of IFRIC 5¹¹. As a result, all such rights to reimbursement are within the scope of IAS 37.
- BC14 The IFRIC noted that paragraph 53 of IAS 37 specifies the accounting for rights to receive reimbursement. It requires this right to reimbursement to be separately recognised when it is virtually certain that reimbursement will be received if the contributor settles the obligation. The IFRIC also noted that this paragraph prohibits the recognition of an asset in excess of the recognised liability. For example, rights to receive reimbursement to meet decommissioning liabilities that have yet to be recognised as a provision are not recognised. Accordingly, the IFRIC concluded that when the right to reimbursement is virtually certain to be received if the contributor settles its decommissioning obligation, it should be measured at the lower of the amount of the decommissioning obligation recognised and the reimbursement right.
- BC15 The IFRIC discussed whether the reimbursement right should be measured at:
- (a) the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs (with any obligation to make good potential defaults of other contributors being treated separately as a contingent liability); or
- (b) the fair value of the reimbursement right (which would normally be lower than (a) because of the risks involved, such as the possibility that the contributor may be required to make good defaults of other contributors).
- BC16 The IFRIC noted that the right to reimbursement relates to a decommissioning obligation for which a provision would be recognised and measured in accordance with IAS 37. Paragraph 36 of IAS 37 requires such provisions to be measured at 'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. The IFRIC noted that the amount in paragraph BC15(a)—ie the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs—is the best estimate of the amount available to the contributor to reimburse it for expenditure it had incurred to pay for decommissioning. Thus, the amount of the asset recognised would be consistent with the amount of the liability recognised.
- BC17 In contrast, the IFRIC noted that the amount in paragraph BC15(b)—ie the fair value of the reimbursement right—would take into account the factors such as liquidity that the IFRIC believed to be difficult to measure reliably. Furthermore, this amount would be lower than that in paragraph BC15(a) because it reflects the possibility that the contributor may be required to make potential additional contributions in the event of default by other contributors. The IFRIC noted that its decision that the obligation to make potential additional contributions should be treated as a contingent liability in accordance with IAS 37 (see paragraphs BC22-BC25) would result in double-counting of the risk of the additional contribution being required if the measure in paragraph BC15(b) were to be used.
- BC18 Consequently, the IFRIC concluded that the approach in paragraph BC15(a) would provide the most useful information to users.

¹¹ The amendment has been incorporated into the text of IAS 39 as published in this volume.

The asset cap

- BC19 Many respondents to D4 expressed concern about the ‘asset cap’ that is imposed by the requirement in paragraph 9. This asset cap limits the amount recognised as a reimbursement asset to the amount of the decommissioning obligation recognised. These respondents argued that rights to benefit in excess of this amount give rise to an additional asset, separate from the reimbursement asset. Such an additional asset may arise in a number of ways, for example:
- (a) the contributor has the right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund.
 - (b) the contributor has the right to benefit from reduced contributions to the fund or increased benefits from the fund (eg by adding new sites to the fund for no additional contributions) in the future.
 - (c) the contributor expects to obtain benefit from past contributions in the future, based on the current and planned level of activity. However, because contributions are made before the decommissioning obligation is incurred, IAS 37 prevents recognition of an asset in excess of the obligation.
- BC20 The IFRIC concluded that a right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund may be an equity instrument within the scope of IAS 39,¹² in which case IAS 39 would apply. However, the IFRIC agreed that an asset should not be recognised for other rights to receive reimbursement from the fund. Although the IFRIC had sympathy with the concerns expressed by constituents that there may be circumstances in which it would seem appropriate to recognise an asset in excess of the reimbursement right, it concluded that it would be inconsistent with paragraph 53 of IAS 37 (which requires that ‘the amount recognised for the reimbursement should not exceed the amount of the provision’) to recognise this asset. The IFRIC also noted that the circumstances in which this additional asset exists are likely to be limited, and apply only when a contributor has restricted access to a surplus of fund assets that does not give it control, joint control or significant influence over a fund. The IFRIC expects that most such assets would not meet the recognition criteria in the *Framework*¹³ because they are highly uncertain and cannot be measured reliably.
- BC21 The IFRIC also considered arguments that there should not be a difference between the treatment of a surplus when a fund is accounted for as a subsidiary, joint venture or associate, and when it is not. However, the IFRIC noted that, under IFRSs, restrictions on assets in subsidiaries, joint ventures or associates do not affect recognition of those assets. Hence it concluded that the difference in treatment between funds accounted for as subsidiaries, joint ventures or associates and those accounted for as a reimbursement right is inherent in IFRSs. The IFRIC also concluded that this is appropriate because, in the former case, the contributor exercises a degree of control not present in the latter case.

Obligations to make additional contributions (paragraph 10)

- BC22 In some cases, a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor.
- BC23 The IFRIC noted that by ‘joining’ the fund, a contributor may assume the position of guarantor of the contributions of the other contributors, and hence become jointly and severally liable for the obligations of other contributors. Such an obligation is a present obligation of the contributor, but the outflow of resources associated with it may not be probable. The IFRIC noted a parallel with the example in paragraph 29 of IAS 37, which states that ‘where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.’ Accordingly, the IFRIC concluded that a liability would be recognised by the contributor only if it is probable that it will make additional contributions. The IFRIC noted that such a contingent liability may arise both when the contributor’s interest in the fund is accounted for as a reimbursement right and when it is accounted for in accordance with IAS 27, IAS 28, IAS 31¹⁴ or SIC-12.

¹² IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

¹³ The reference to the *Framework* is to IASB’s *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

¹⁴ IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

- BC24 The IFRIC considered the argument that an obligation to make good potential shortfalls of other contributors is a financial instrument (ie a financial guarantee) as defined in IAS 32 and hence should be accounted for in accordance with IAS 39.¹⁵ The grounds for this point of view are that the contributor has an obligation to deliver cash to the fund, and the fund has a right to receive cash from the contributor if a shortfall in contributions arises. However, the IFRIC noted that:
- (a) a contractual obligation to make good shortfalls of other contributors is a financial guarantee. Financial guarantee contracts that provide for payments to be made if the debtor fails to make payment when due are excluded from the scope of IAS 39.
 - (b) when the obligation is not contractual, but rather arises as a result of regulation, it is not a financial liability as defined in IAS 32 nor is it within the scope of IAS 39.
- BC25 Therefore, the IFRIC concluded that an obligation to make additional contributions in the event of specified circumstances should be treated as a contingent liability in accordance with IAS 37.

Disclosure (paragraphs 11-13)

- BC26 The IFRIC noted that the contributor may not be able to access the assets of the fund (including cash or cash equivalents) for many years (eg until it undertakes the decommissioning), if ever. Therefore, the IFRIC concluded that the nature of the contributor's interest and the restriction on access should be disclosed. The IFRIC also concluded that this disclosure is equally relevant when a contributor's interest in a fund is accounted for by consolidation, proportional consolidation¹⁶ or using the equity method because the contributor's ability to access the underlying assets may be similarly restricted.

Effective date and transition (paragraphs 14 and 15)

- BC27 D4 proposed that the Interpretation should be effective for annual periods beginning on a date set at three months after the Interpretation was finalised. The IFRIC considered the view of some respondents that the Interpretation should apply from 1 January 2005 (an earlier date) on the grounds that this is the date from which many entities will adopt IFRSs, and hence adopting the Interpretation at that time would promote comparability between periods. However, the IFRIC noted its general practice is to allow at least three months between finalising an Interpretation and its application, to enable entities to obtain the Interpretation and implement any necessary systems changes. In addition, the IFRIC considered the Board's concern that the amendment to IAS 39¹⁵ issued as part of the Interpretation would change the 'stable platform' of Standards that are in force for entities that will apply IFRSs for the first time in 2005. Therefore, the IFRIC decided to require that the Interpretation should be applied for annual periods beginning on or after 1 January 2006, with earlier application encouraged.
- BC28 The IFRIC observed that the implementation of the Interpretation is not expected to be problematic. Therefore, the IFRIC concluded that IAS 8 should apply. Respondents to D4 did not disagree with this conclusion.

¹⁵ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

¹⁶ IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31. IFRS 11 does not permit an entity to use 'proportionate consolidation' for accounting for interests in joint ventures.

Effective for annual periods
beginning on or after 1 November 2006

HK(IFRIC) Interpretation 10

Interim Financial Reporting and Impairment



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Hong Kong (IFRIC) Interpretation 10 *Interim Financial Reporting and Impairment* (HK(IFRIC)-Int 10) is set out in paragraphs 1–140. HK(IFRIC)-Int 10 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 10

Interim Financial Reporting and Impairment

References

- HKFRS 9 *Financial Instruments*
- HKAS 34 *Interim Financial Reporting*
- HKAS 36 *Impairment of Assets*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~

Background

- 1 An entity is required to assess goodwill for impairment at the end of each reporting period, ~~to assess investments in equity instruments and in financial assets carried at cost for impairment at the end of each reporting period and~~, if required, to recognise an impairment loss at that date in accordance with HKAS 36 ~~and HKAS 39~~. However, at the end of a subsequent reporting period, conditions may have so changed that the impairment loss would have been reduced or avoided had the impairment assessment been made only at that date. This Interpretation provides guidance on whether such impairment losses should ever be reversed.
- 2 The Interpretation addresses the interaction between the requirements of HKAS 34 and the recognition of impairment losses on goodwill in HKAS 36 ~~and certain financial assets in HKAS 39~~, and the effect of that interaction on subsequent interim and annual financial statements.

Issue

- 3 HKAS 34 paragraph 28 requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. It also states that 'the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.'
- 4 HKAS 36 paragraph 124 states that 'An impairment loss recognised for goodwill shall not be reversed in a subsequent period.'
- 5 ~~HKAS 39 paragraph 69 states that 'Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.'~~[Deleted]
- 6 ~~HKAS 39 paragraph 66 requires that impairment losses for financial assets carried at cost (such as an impairment loss on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured) should not be reversed.~~[Deleted]
- 7 The Interpretation addresses the following issue:

Should an entity reverse impairment losses recognised in an interim period on goodwill ~~and investments in equity instruments and in financial assets carried at cost~~ if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period?

Conclusions

- 8 An entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill ~~or an investment in either an equity instrument or a financial asset carried at cost.~~
- 9 An entity shall not extend this conclusion by analogy to other areas of potential conflict between HKAS 34 and other standards.

Effective date and transition

- 10 An entity shall apply the Interpretation for annual periods beginning on or after 1 November 2006. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 November 2006, it shall disclose that fact. An entity shall apply the Interpretation to goodwill prospectively from the date at which it first applied HKAS 36; it shall apply the Interpretation to investments in equity instruments or in financial assets carried at cost prospectively from the date at which it first applied the measurement criteria of HKAS 39.

11- [Deleted]

13

- 14 HKFRS 9, as issued in September 2014, amended paragraphs 1, 2, 7, and 8 and deleted paragraphs 5, 6, 11-13. An entity shall apply those amendments when it applies HKFRS 9.

Basis for Conclusions on IFRIC Interpretation 10 *Interim Financial Reporting and Impairment*

This Basis for Conclusions accompanies, but is not part of, IFRIC 10.

HK(IFRIC)-Int 10 is based on IFRIC Interpretation 10 *Interim Financial Reporting and Impairment*. In approving HK(IFRIC)-Int 10, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 10. Accordingly, there are no significant differences between HK(IFRIC)-Int 10 and IFRIC Interpretation 10. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 10 referred to below generally correspond with those in HK(IFRIC)-Int 10.

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.
- BC2 IAS 34 requires an entity to apply the same accounting policies in its interim financial statements as it applies in its annual financial statements. For annual financial statements, IAS 36 prohibits an entity from reversing an impairment loss on goodwill that it recognised in a prior annual period. Similarly, IAS 39* prohibits an entity from reversing in a subsequent annual period an impairment loss on an investment in an equity instrument or in a financial asset carried at cost. These requirements might suggest that an entity should not reverse in a subsequent interim period an impairment loss on goodwill or an investment in an equity instrument or in a financial asset carried at cost that it had recognised in a prior interim period. Such impairment losses would not be reversed even if no loss, or a smaller loss, would have been recognised had the impairment been assessed only at the end of the subsequent interim period.
- BC3 However, IAS 34 requires year-to-date measures in interim financial statements. This requirement might suggest that an entity should reverse in a subsequent interim period an impairment loss it recognised in a prior interim period. Such impairment losses would be reversed if no loss, or a smaller loss, would have been recognised had the impairment been assessed only at the end of the subsequent interim period.
- BC4 The IFRIC released Draft Interpretation D18 *Interim Financial Reporting and Impairment* for public comment in January 2006. It received more than 50 letters in response.
- BC5 The IFRIC noted that many of the respondents believed that in attempting to address contradictions between standards, D18 was beyond the scope of the IFRIC. Some believed that the issue addressed could be better resolved by amending IAS 34. Before finalising its views, the IFRIC asked the International Accounting Standards Board to consider this point. The Board, however, did not wish to amend IAS 34 and asked the IFRIC to continue with its Interpretation.
- BC6 Respondents to D18 were divided on whether the proposed Interpretation should prohibit the reversal of impairment losses on goodwill or investments in equity instruments or in financial assets carried at cost that had been recognised in interim periods. The IFRIC considered these responses but maintained its view that such losses should not be reversed in subsequent financial statements. The IFRIC observed that the wide divergence of views evident from respondents' letters underlined the need for additional guidance and it therefore decided to issue the Interpretation with few changes from D18.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC7 The IFRIC considered the example of Entity A and Entity B, which each hold the same equity investment with the same acquisition cost. Entity A prepares quarterly interim financial statements and Entity B prepares half-yearly financial statements. The entities have the same year-end. The IFRIC noted that if there was a significant decline in the fair value of the equity instrument below its cost in the first quarter, Entity A would recognise an impairment loss in its first quarter interim financial statements. However, if the fair value of the equity instrument subsequently recovered, so that by the half-year date there had not been a significant decline in fair value below cost, Entity B would not recognise an impairment loss in its half-yearly financial statements if it tested for impairment only at its half-yearly reporting dates. Therefore, unless Entity A reversed the impairment loss that had been recognised in an earlier interim period, the frequency of reporting would affect the measurement of its annual results when compared with Entity B's approach. The IFRIC also noted that the recognition of an impairment loss could similarly be affected by the timing of the financial year-ends of the two entities.
- BC8 The IFRIC noted ~~the illustrative examples paragraph B36 of Appendix B accompanying IAS 34 provide, which provides~~ examples of applying the general recognition and measurement principles of that standard, and states that IAS 34 requires an entity to apply the same impairment testing, recognition, and reversal criteria at an interim date as it would at the end of its financial year.
- BC9 The IFRIC concluded that the prohibitions on reversals of recognised impairment losses on goodwill in IAS 36 and on investments in equity instruments and in financial assets carried at cost in IAS 39[#] should take precedence over the more general statement in IAS 34 regarding the frequency of an entity's reporting not affecting the measurement of its annual results.
- BC10 Furthermore, the IFRIC concluded that the rationale for the non-reversal of impairment losses relating to goodwill and investments in equity instruments, as set out in paragraph BC189 of IAS 36 and paragraph BC130 of IAS 39, applies at both interim and annual reporting dates.
- BC11 The IFRIC considered a concern that this conclusion could be extended to other areas of potential conflict between IAS 34 and other standards. The IFRIC has not studied those areas and therefore has not identified any general principles that might apply both to the Interpretation and to other areas of potential conflict. The IFRIC therefore added a prohibition against extending the consensus by analogy to other areas of potential conflict between IAS 34 and other standards.
- BC12 D18 proposed fully retrospective application. A number of comment letters stated that this could be read as being more onerous than the first-time adoption requirements of IAS 36. The IFRIC revised the wording of the transition requirements to make clear that the Interpretation should not be applied to periods before an entity's adoption of IAS 36 in the case of goodwill impairments and IAS 39 in the case of impairments of investments in equity instruments or in financial assets carried at cost.

[#] In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

HK(IFRIC)-Int 12
Revised September 2018~~January 2017~~

Effective for annual periods
beginning on or after 1 January 2008

HK(IFRIC) Interpretation 12

Service Concession Arrangements



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Hong Kong (IFRIC) Interpretation 12

Service Concession Arrangements

References

- *Framework for the Preparation and Presentation of Financial Statements*¹
- HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*
- ~~HKFRS 7 *Financial Instruments: Disclosures*~~
- ~~HKFRS 9 *Financial Instruments*~~
- ~~HKFRS 15 *Revenue from Contracts with Customers*~~
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- ~~HKAS 11 *Construction Contracts*~~
- HKAS 16 *Property, Plant and Equipment*
- HKAS 17 *Leases*
- ~~HKAS 18 *Revenue*~~
- HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- HKAS 23 *Borrowing Costs*
- HKAS 32 *Financial Instruments: Presentation*
- HKAS 36 *Impairment of Assets*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- HKAS 38 *Intangible Assets*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~
- HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*
- HK(SIC)-Int 29 *Service Concession Arrangements: Disclosures*²

Background

- 1 In many countries, infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.
- 2 In some countries, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure. The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Interpretation typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a ‘build-operate-transfer’, a ‘rehabilitate-operate-transfer’ or a ‘public-to-private’ service concession arrangement.

¹ *Framework for the Preparation and Presentation of Financial Statements* was replaced by the *Conceptual Framework for Financial Reporting* in October 2010.

² The title of HK(SIC)-Int 29, formerly *Disclosure – Service Concession Arrangements*, was amended by HK(IFRIC)-Int 12.

Issues

- 10 This Interpretation sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements. Requirements for disclosing information about service concession arrangements are in HK(SIC)-Int 29. The issues addressed in this Interpretation are:
- (a) treatment of the operator's rights over the infrastructure;
 - (b) recognition and measurement of arrangement consideration;
 - (c) construction or upgrade services;
 - (d) operation services;
 - (e) borrowing costs;
 - (f) subsequent accounting treatment of a financial asset and an intangible asset; and
 - (g) items provided to the operator by the grantor.

Conclusions

Treatment of the operator's rights over the infrastructure

- 11 Infrastructure within the scope of this Interpretation shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

Recognition and measurement of arrangement consideration

- 12 Under the terms of contractual arrangements within the scope of this Interpretation, the operator acts as a service provider. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.
- 13 The operator shall recognise and measure revenue in accordance with HKFRS 15~~HKASs 11 and 18~~ for the services it performs. ~~If the operator performs more than one service (ie construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable. The nature of the consideration determines its subsequent accounting treatment. The subsequent accounting for consideration received as a financial asset and as an intangible asset is detailed in paragraphs 23-26 below.~~

Construction or upgrade services

- 14 The operator shall account for ~~revenue and costs relating to~~ construction or upgrade services in accordance with ~~HKAS 11~~HKFRS 15.

Consideration given by the grantor to the operator

- 15 If the operator provides construction or upgrade services the consideration received or receivable by the operator shall be recognised in accordance with HKFRS 15~~at its fair value~~. The consideration may be rights to:
- (a) a financial asset, or
 - (b) an intangible asset.
- 16 The operator shall recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.
- 17 The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.
- 18 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially in accordance with HKFRS 15~~at the fair value of the consideration received or receivable~~.
- 19 The nature of the consideration given by the grantor to the operator shall be determined by reference to the contract terms and, when it exists, relevant contract law. The nature of the consideration determines the subsequent accounting as described in paragraphs 23-26. However, both types of consideration are classified as a contract asset during the construction or upgrade period in accordance with HKFRS 15.

Operation services

- 20 The operator shall account for ~~revenue and costs relating to operation services in~~ accordance with HKFRS 15~~HKAS 18~~.

Contractual obligations to restore the infrastructure to a specified level of serviceability

- 21 The operator may have contractual obligations it must fulfil as a condition of its licence (a) to maintain the infrastructure to a specified level of serviceability or (b) to restore the infrastructure to a specified condition before it is handed over to the grantor at the end of the service arrangement. These contractual obligations to maintain or restore infrastructure, except for any upgrade element (see paragraph 14), shall be recognised and measured in accordance with HKAS 37, ie at the best estimate of the expenditure that would be required to settle the present obligation at the end of the reporting period.

Borrowing costs incurred by the operator

- 22 In accordance with HKAS 23, borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service). In this case borrowing costs attributable to the arrangement shall be capitalised during the construction phase of the arrangement in accordance with that Standard.

Financial asset

- 23 HKASs 32 and ~~39~~ and HKFRSs 7 and 9 apply to the financial asset recognised under paragraphs 16 and 18.
- 24 The amount due from or at the direction of the grantor is accounted for in accordance with HKFRS 9~~HKAS 39~~ as measured at:
- (a) ~~amortised cost~~ a loan or receivable; or
 - (b) fair value through other comprehensive income~~an available-for-sale financial asset~~; or
 - (c) ~~if so designated upon initial recognition, a financial asset at fair value through profit or loss, if the conditions for that classification are met.~~
- 25 If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive income~~accounted for either as a loan or receivable or as an available-for-sale financial asset~~, HKFRS 9~~HKAS 39~~ requires interest calculated using the effective interest method to be recognised in profit or loss.

Intangible asset

- 26 HKAS 38 applies to the intangible asset recognised in accordance with paragraphs 17 and 18. Paragraphs 45-47 of HKAS 38 provide guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

Items provided to the operator by the grantor

- 27 In accordance with paragraph 11, infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator. The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in HKAS 20. ~~They are recognised as assets of the operator, measured at fair value on initial recognition. The operator shall recognise a liability in respect of unfulfilled obligations it has assumed in exchange for the assets. Instead, they are accounted for as part of the transaction price as defined in HKFRS 15.~~

Effective date

- 28 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2008. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 January 2008, it shall disclose that fact.
- ~~28A- [Deleted]~~
- ~~28C~~
- ~~28D HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended the 'References' section, the table in Information note 2 and paragraphs 13-15, 18-20 and 27. An entity shall apply those amendments when it applies HKFRS 15.~~
- ~~28E HKFRS 9, as issued in September 2014, amended paragraphs 23-25 and deleted paragraphs 28A-28C. An entity shall apply those amendments when it applies HKFRS 9.~~

Transition

- 29 Subject to paragraph 30, changes in accounting policies are accounted for in accordance with HKAS 8, ie retrospectively.
- 30 If, for any particular service arrangement, it is impracticable for an operator to apply this Interpretation retrospectively at the start of the earliest period presented, it shall:
- (a) recognise financial assets and intangible assets that existed at the start of the earliest period presented;
 - (b) use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date; and
 - (c) test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

Information note 2

References to IFRSs that apply to typical types of public-to-private arrangements

This note accompanies, but is not part of, IFRIC 12.

The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to IFRSs that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not the IFRIC's intention to convey the impression that bright lines exist between the accounting requirements for public-to-private arrangements.

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (eg Operator leases assets from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/Privatisation/Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8–20 years	1–5 years	25-30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant IFRSs	IAS 17	~~IFRS 15~~ IAS 18	IFRIC 12		IAS 16	

Illustrative examples

These examples accompany, but are not part of, IFRIC 12.

Example 1: The grantor gives the operator a financial asset

Arrangement terms

- IE1 The terms of the arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road at the end of year 8—the resurfacing activity is revenue-generating. At the end of year 10, the arrangement will end. Assume that the operator identifies three performance obligations for construction services, operation services and road resurfacing. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1.1 Contract costs

	Year	CU*
Construction services	1	500
	2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in 'currency units (CU) '.

- IE2 The terms of the arrangement require the grantor to pay the operator 200 currency units (CU200) per year in years 3-10 for making the road available to the public.
- IE3 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Contract revenue

- IE4 The operator recognises ~~contract revenue and costs~~ in accordance with IFRS 15 Revenue from Contracts with Customers, ~~IAS 11 Construction Contracts~~ and ~~IAS 18 Revenue~~. ~~The costs of each activity—construction, operation and resurfacing—are recognised as expenses by reference to the stage of completion of that activity. Contract revenue—the fair value of Revenue—the amount due of consideration to which the operator expects to be entitled from the grantor for the activity undertaken—services provided—is recognised at the same time when (or as) the performance obligations are satisfied.~~ Under the terms of the arrangement the operator is obliged to resurface the road at the end of year 8. In year 8 the operator will be reimbursed by the grantor for resurfacing the road. ~~The obligation to resurface the road is measured at zero in the statement of financial position and the revenue and expense are not recognised in profit or loss until the resurfacing work is performed.~~
- IE5 The total ~~excepted~~ consideration (CU200 in each of years 3—810) ~~reflects the fair values for each of the services, which are~~ allocated to the performance obligations based on the relative stand-alone selling prices of the construction services, operation services and road resurfacing, taking into account the significant financing component, as follows:

~~Table 1.2 Fair values of the consideration received or receivable~~

	Fair value		
Construction services	Forecast cost	±	5%
Operation services	"	±	20%
Road resurfacing	"	±	10%
Effective interest rate	6.18% per year		

Table 1.2 Transaction price allocated to each performance obligation

	Transaction price allocation (including effect of the significant financing component)
	<u>CU</u>
<u>Construction services (over two years)^(a)</u>	<u>1,050</u>
<u>Operation services (over 8 years)^(b)</u>	<u>96</u>
<u>Road resurfacing services (in year 8)^(c)</u>	<u>110</u>
<u>Total</u>	<u><u>1,256</u></u>
<u>Implied interest rate^(d)</u>	<u>6.18% per year</u>
<u>(a) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 5 per cent.</u> <u>(b) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 20 per cent.</u> <u>(c) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 10 per cent.</u> <u>(d) The implied interest rate is assumed to be the rate that would be reflected in a financing transaction between the operator and the grantor.</u>	

- IE6 In year 1, for example, construction costs of CU500, construction revenue of CU525 (~~cost plus 5 per cent~~), and hence construction profit of CU25 are recognised in profit or loss.

Financial asset

- IE7 ~~The amounts due from the grantor meet the definition of a receivable in IAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments. During the first two years, the entity recognises a contract asset and accounts for the significant financing component in the arrangement in accordance with IFRS 15. Once the construction is complete, the amounts due from the grantor are accounted for in accordance with IFRS 9 *Financial Instruments* as receivables.~~
- IE8 If the cash flows and fair values remain the same as those forecast, the effective interest rate is 6.18 per cent per year and the receivable recognised at the end of years 1-3 will be:

Table 1.3 Measurement of contract asset/receivable

	CU
Amount due for construction in year 1	525
Receivable/Contract asset at end of year 1*	525
Effective interest in year 2 on ~~receivable~~ <u>contract asset</u> at the end of year 1 (6.18% x CU525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	1,082
Effective interest in year 3 on receivable at the end of year 2 (6.18% x CU1,082)	67
Amount due for operation in year 3 (CU10 x (1+20%))	12
Cash receipts in year 3	(200)
Receivable at end of year 3	961

- * No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year.

Overview of cash flows, statement of comprehensive income and statement of financial position

- IE9 For the purpose of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be:

Table 1.4 Cash flows (currency units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

- * Table 1.1

- † Debt at start of year (table 1.6) x 6.7%

Example 2: The grantor gives the operator an intangible asset (a licence to charge users)

Arrangement terms

- IE11 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the service arrangement will end. Assume that the operator identifies a single performance obligation for construction services. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 2.1 Contract costs

	Year	CU*
Construction services	1	500
	2	500
~~Operation services~~ <u>Operating the road (per year)</u>	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in 'currency units (CU) '.

- IE12 The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of 200 currency units (CU200) in each of years 3-10.
- IE13 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Intangible asset

- IE14 The operator provides construction services to the grantor in exchange for an intangible asset, ie a right to collect tolls from road users in years 3-10. In accordance with IFRS 15, the operator measures this non-cash consideration at fair value. In this case, the operator determines the fair value indirectly by reference to the stand-alone selling price of IAS 38 Intangible Assets, the operator recognises the intangible asset at cost, ie the fair value of consideration transferred to acquire the asset, which is the fair value of the consideration received or receivable for the construction services delivered.
- IE15 During the construction phase of the arrangement the operator's contract asset (representing its accumulating right to be paid for providing construction services) is classified presented as an intangible asset (licence to charge users of the infrastructure). ~~The operator measures estimates the fair value of its consideration received stand-alone selling price of the construction services to be as equal to the forecast construction costs plus 5 per cent margin, which the operator concludes is consistent with the rate that a market participant would require as compensation for providing the construction services and for assuming the risk associated with the construction costs. It is also assumed that, in accordance with IAS 23 Borrowing Costs, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase of the arrangement:~~

Table 2.2 Initial measurement of intangible asset

	CU
Construction services in year 1 ($CU500 \times (1 + 5\%)$)	525
Capitalisation of borrowing costs (table 2.4)	34
Construction services in year 2 ($CU500 \times (1 + 5\%)$)	525
Intangible asset at end of year 2	1,084

- IE16 In accordance with IAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3-10. The depreciable amount of the intangible asset (CU1,084) is allocated using a straight-line method. The annual amortisation charge is therefore CU1,084 divided by 8 years, ie CU135 per year.

Construction costs and revenue

- IE17 The operator ~~recognises the revenue and costs accounts for the construction services in accordance with IFRS 15/IAS 11 Construction Contracts, ie by reference to the stage of completion of the construction.~~ It measures contract revenue at the fair value of the non-cash consideration received or receivable. Thus in each of years 1 and 2 it recognises in its profit or loss construction costs of CU500, construction revenue of CU525 ~~(cost plus 5 per cent)~~ and, hence, construction profit of CU25.

Toll revenue

- IE18 The road users pay for the public services at the same time as they receive them, ie when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

Resurfacing obligations

- IE19 The operator's resurfacing obligation arises as a consequence of use of the road during the operating phase. It is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- IE20 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 (discounted to a current value) each year. The operator discounts the provision to its present value in accordance with IAS 37. The charge recognised each period in profit or loss is:

Table 2.3 Resurfacing obligation (currency units)

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	12	14	15	17	20	22	100

Overview of cash flows, statement of comprehensive income and statement of financial position

- IE21 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be:

Example 3: The grantor gives the operator a financial asset and an intangible asset

Arrangement terms

- IE23 The terms of a service arrangement require an operator to construct a road—completing construction within two years—and to operate the road and maintain it to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the arrangement will end. Assume that the operator identifies a single performance obligation for construction services. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 3.1 Contract costs

	Year	CU*
Construction services	1	500
	2	500
~~Operation services~~ <u>Operating the road</u> (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in 'currency units' (CU).

- IE24 The operator estimates the consideration in respect of construction services to be CU1,050 by reference to the stand-alone selling price of those services (which it estimates at forecast cost plus 5 per cent).
- IE25 The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of CU700 and interest at a specified rate of 6.18% to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3-10.
- IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Dividing the arrangement

- IE27 The contractual right to receive cash from the grantor for the services and the right to charge users for the public services should be regarded as two separate assets under IFRSs. Therefore in this arrangement it is necessary to divide the operator's ~~consideration~~ contract asset during the construction phase into two components—a financial asset component based on the guaranteed amount and an intangible asset for the remainder. When the construction services are completed, the two components of the contract asset would be classified and measured as a financial asset and an intangible asset accordingly.

Table 3.2 Dividing the operator's consideration

Year	Total	Financial asset	Intangible asset
Construction services in year 1 ($CU500 \times (1 + 5\%)$)	525	350	175
Construction services in year 2 ($CU500 \times (1 + 5\%)$)	525	350	175
Total construction services	1,050	700	350
	100%	67%*	33%
Finance income, at specified rate of 6.18% on receivable (see table 3.3)	22	22	-
Borrowing costs capitalised (interest paid in years 1 and 2 $\times$ 33%)(see table 3.7)	11	-	11
Total fair value of the operator's consideration	1,083	722	361

* Amount guaranteed by the grantor as a proportion of the construction services

Financial asset

- IE28 ~~The amount due from or at the direction of the grantor in exchange for the construction services meets the definition of a receivable in IAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments. During the first two years, the entity recognises a contract asset and accounts for the significant financing component in the arrangement in accordance with IFRS 15. Once the construction is complete, the amount due from, or at the direction of, the grantor in exchange for the construction services is accounted for in accordance with IFRS 9 as a receivable.~~
- IE29 On this basis the receivable recognised at the end of years 2 and 3 will be:

Table 3.3 Measurement of contract asset/receivable

	CU
Construction services in year 1 allocated to the ~~financial~~ <u>contract asset</u>	350
<u>Receivable/Contract asset</u> at end of year 1	350
Construction services in year 2 allocated to the ~~financial~~ <u>contract asset</u>	350
Interest in year 2 on ~~receivable~~ <u>contract asset</u> at end of year 1 ($6.18\% \times CU350$)	22
<u>Receivable</u> at end of year 2	722
Interest in year 3 on receivable at end of year 2 ($6.18\% \times CU722$)	45
Cash receipts in year 3 (see table 3.5)	(117)
<u>Receivable</u> at end of year 3	650

Intangible asset

- IE30 In accordance with IAS 38 *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of the consideration received or receivable.
- IE31 During the construction phase of the arrangement the portion of the operator's contract asset that (represents/representing its accumulating right to be paid amounts in excess of the guaranteed amount for providing construction services) is classified presented as a right to receive a licence to charge users of the infrastructure. The operator measures estimates the fair value of its consideration received or receivable stand-alone selling price of the construction services as equal to the forecast construction costs plus 5 per cent, which the operator concludes is consistent with the rate that a market participant would require as compensation for providing the construction services and for assuming the risk associated with the construction costs. It is also assumed that, in accordance with IAS 23 *Borrowing Costs*, the operator capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase:

Table 3.4 Initial measurement of intangible asset

	CU
Construction services in year 1 ($CU500 \times (1 + 5\%) \times 33\%$)	175
Borrowing costs (interest paid in years 1 and 2 $\times 33\%$) (see table 3.7)	11
Construction services in year 2 ($CU500 \times (1 + 5\%) \times 33\%$)	175
Intangible asset at the end of year 2	361

- IE32 In accordance with IAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3-10. The depreciable amount of the intangible asset (CU361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore CU361 divided by 8 years, ie CU45 per year.

Contract revenue

- IE33 The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator ~~recognises contract revenue and costs accounts for the construction services in accordance with IFRS 15, IAS 11 Construction Contracts, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration receivable.~~ Thus in each of years 1 and 2 it recognises in profit or loss construction costs of CU500 and construction revenue of CU525 ~~(cost plus 5 per cent).~~

Toll revenue

- IE34 The road users pay for the public services at the same time as they receive them, ie when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset:

Table 3.5 Allocation of toll receipts

Year	CU
Guaranteed receipt from grantor	700
Finance income (see table 3.8)	237
Total	937
Cash allocated to realisation of the financial asset per year (CU937 / 8 years)	117
Receipts attributable to intangible asset ($CU200 \times 8 \text{ years} - CU937$)	663
Annual receipt from intangible asset (CU663 / 8 years)	83

Resurfacing obligations

- IE35 The operator's resurfacing obligation arises as a consequence of use of the road during the operation phase. It is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Basis for Conclusions on IFRIC Interpretation 12 Service Concession Arrangements

This Basis for Conclusions accompanies, but is not part of, IFRIC 12.

HK(IFRIC)-Int 12 is based on IFRIC Interpretation 12 *Service Concession Arrangements*. In approving HK(IFRIC)-Int 12, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 12. Accordingly, there are no significant differences between HK(IFRIC)-Int 12 and IFRIC Interpretation 12. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 12 referred to below generally correspond with those in HK(IFRIC)-Int 12.

Introduction

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

- BC2 SIC-29 *Service Concession Arrangements: Disclosures* (formerly *Disclosure—Service Concession Arrangements*) contains disclosure requirements in respect of public-to-private service arrangements, but does not specify how they should be accounted for.
- BC3 There was widespread concern about the lack of such guidance. In particular, operators wished to know how to account for infrastructure that they either constructed or acquired for the purpose of a public-to-private service concession arrangement, or were given access to for the purpose of providing the public service. They also wanted to know how to account for other rights and obligations arising from these types of arrangements.
- BC4 In response to this concern, the International Accounting Standards Board asked a working group comprising representatives of the standard-setters of Australia, France, Spain and the United Kingdom (four of the countries that had expressed such concern) to carry out initial research on the subject. The working group recommended that the IFRIC should seek to clarify how certain aspects of existing accounting standards were to be applied.
- BC5 In March 2005 the IFRIC published for public comment three draft Interpretations: D12 *Service Concession Arrangements—Determining the Accounting Model*, D13 *Service Concession Arrangements—The Financial Asset Model* and D14 *Service Concession Arrangements—The Intangible Asset Model*. In response to the proposals 77 comment letters were received. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretations, IASB staff met various interested parties, including preparers, auditors and regulators.
- BC6 Most respondents to D12-D14 supported the IFRIC's proposal to develop an Interpretation. However, nearly all respondents expressed concern with fundamental aspects of the proposals, some urging that the project be passed to the Board to develop a comprehensive standard.
- BC7 In its redeliberation of the proposals the IFRIC acknowledged that the project was a large undertaking but concluded that it should continue its work because, given the limited scope of the project, it was by then better placed than the Board to deal with the issues in a timely way.

- (c) rights are often unbundled. For example, they may be divided proportionately (undivided interests in land) or by specified cash flows (principal and interest on a bond) or over time (a lease).
- BC21 The IFRIC concluded that treatment of infrastructure that the operator constructs or acquires or to which the grantor gives the operator access for the purpose of the service arrangement should be determined by whether it is controlled by the grantor in the manner described in paragraph 5. If it is so controlled (as will be the case for all arrangements within the scope of the Interpretation), then, regardless of which party has legal title to it during the arrangement, the infrastructure should not be recognised as property, plant and equipment of the operator because the operator does not control the use of the public service infrastructure.
- BC22 In reaching this conclusion the IFRIC observed that it is control of the right to use an asset that determines recognition under IAS 16 and the creation of a lease under IAS 17 *Leases*. IAS 16 defines property, plant and equipment as tangible items that 'are held for use in the production or supply of goods or services, for rental to others or for administrative purposes ...'. It requires items within this definition to be recognised as property, plant and equipment unless another standard requires or permits a different approach. As an example of a different approach, it highlights the requirement in IAS 17 for recognition of leased property, plant and equipment to be evaluated on the basis of the transfer of risks and rewards. That standard defines a lease as 'an agreement whereby the lessor conveys to the lessee in return for a series of payments the right to use an asset' and it sets out the requirements for classification of leases. IFRIC 4 *Determining whether an Arrangement contains a Lease* interprets the meaning of right to use an asset as 'the arrangement conveys the right to control the use of the underlying asset.'
- BC23 Accordingly, it is only if an arrangement conveys the right to control the use of the underlying asset that reference is made to IAS 17 to determine how such a lease should be classified. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
- BC24 The IFRIC considered whether arrangements within the scope of IFRIC 12 convey 'the right to control the use of the underlying asset' (the public service infrastructure) to the operator. The IFRIC decided that, if an arrangement met the conditions in paragraph 5, the operator would not have the right to control the use of the underlying asset and should therefore not recognise the infrastructure as a leased asset.
- BC25 In arrangements within the scope of the Interpretation the operator acts as a service provider. The operator constructs or upgrades infrastructure used to provide a public service. Under the terms of the contract the operator has access to operate the infrastructure to provide the public service on the grantor's behalf. The asset recognised by the operator is the consideration it receives in exchange for its services, not the public service infrastructure that it constructs or upgrades.
- BC26 Respondents to the draft Interpretations disagreed that recognition should be determined solely on the basis of control of use without any assessment of the extent to which the operator or the grantor bears the risks and rewards of ownership. They questioned how the proposed approach could be reconciled to IAS 17, in which the leased asset is recognised by the party that bears substantially all the risks and rewards incidental to ownership.
- BC27 During its redeliberation the IFRIC affirmed its decision that if an arrangement met the control conditions in paragraph 5 of the Interpretation the operator would not have the right to control the use of the underlying asset (public service infrastructure) and should therefore not recognise the infrastructure as its property, plant and equipment under IAS 16 or the creation of a lease under IAS 17. The contractual service arrangement between the grantor and operator would not convey the right to use the infrastructure to the operator. The IFRIC concluded that this treatment is also consistent with IAS 18 *Revenue*^{*} because, for arrangements within the scope of the Interpretation, the second

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*.

condition of paragraph 14 of IAS 18 is not satisfied. The grantor retains continuing managerial involvement to the degree usually associated with ownership and control over the infrastructure as described in paragraph 5.

- BC28 In service concession arrangements rights are usually conveyed for a limited period, which is similar to a lease. However, for arrangements within the scope of the Interpretation, the operator's right is different from that of a lessee: the grantor retains control over the use to which the infrastructure is put, by controlling or regulating what services the operator must provide, to whom it must provide them, and at what price, as described in paragraph 5(a). The grantor also retains control over any significant residual interest in the infrastructure throughout the period of the arrangement. Unlike a lessee, the operator does not have a right of use of the underlying asset: rather it has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.
- BC29 The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 4. In particular, it noted the views expressed by some respondents that the contractual terms of certain service arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion set out in paragraph 5 of IFRIC 12. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. In the light of comments received the IFRIC amended the scope of IFRIC 4 to specify that if a service arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

Recognition and measurement of arrangement consideration (paragraphs 12 and 13)

- BC30 The accounting requirements for construction and service contracts are addressed in IAS 11 *Construction Contracts*^{*} and IAS 18^{*}. They require revenue to be recognised by reference to the stage of completion of the contract activity. IAS 18 states the general principle that revenue is measured at the fair value of the consideration received or receivable. However, the IFRIC observed that the fair value of the construction services delivered may in practice be the most appropriate method of establishing the fair value of the consideration received or receivable for the construction services. This will be the case in service concession arrangements, because the consideration attributable to the construction activity often has to be apportioned from a total sum receivable on the contract as a whole and, if it consists of an intangible asset, may also be subject to uncertainty in measurement.
- BC31 The IFRIC noted that IAS 18^{*} requires its recognition criteria to be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and is recognised as revenue over the period during which the service is performed. The IFRIC concluded that this requirement was relevant to service arrangements within the scope of the Interpretation. Arrangements within the scope of the Interpretation involve an operator providing more than one service, ie construction or upgrade services, and operation services. Although the contract for each service is generally negotiated as a single contract, its terms call for separate phases or elements because each separate phase or element has its own distinct skills, requirements and risks. The IFRIC noted that, in these circumstances, IAS 18 paragraphs 4 and 13 require the contract to be separated into two separate phases or elements, a construction element within the scope of IAS 11^{*} and an operations element within the scope of IAS 18. Thus the operator might report different profit margins on each phase or element. The IFRIC noted that the amount for each service would be identifiable because such services were often provided as a single service. The IFRIC also noted that the combining and segmenting criteria of IAS 11 applied only to the construction element of the arrangement.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts* and IAS 18 *Revenue*. IFRS 15 requires revenue to be recognised when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer. IFRS 15 measures the revenue by (a) determining the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer; and (b) allocating that amount to the performance obligations.

BC32 In some circumstances, the grantor makes a non-cash payment for the construction services, ie it gives the operator an intangible asset (a right to charge users of the public service) in exchange for the operator providing construction services. The operator then uses the intangible asset to generate further revenues from users of the public service.

BC33 Paragraph 12 of IAS 18^{*} states:

When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

BC34 The IFRIC noted that total revenue does not equal total cash inflows. The reason for this outcome is that, when the operator receives an intangible asset in exchange for its construction services, there are two sets of inflows and outflows rather than one. In the first set, the construction services are exchanged for the intangible asset in a barter transaction with the grantor. In the second set, the intangible asset received from the grantor is used up to generate cash flows from users of the public service. This result is not unique to service arrangements within the scope of the Interpretation. Any situation in which an entity provides goods or services in exchange for another dissimilar asset that is subsequently used to generate cash revenues would lead to a similar result.

BC35 Some IFRIC members were uncomfortable with such a result, and would have preferred a method of accounting under which total revenues were limited to the cash inflows. However, they accepted that it is consistent with the treatment accorded to a barter transaction, ie an exchange of dissimilar goods or services.

Consideration given by the grantor to the operator (paragraphs 14–19)

BC36 The IFRIC observed that the contractual rights that the operator receives in exchange for providing construction services can take a variety of forms. They are not necessarily rights to receive cash or other financial assets.

BC37 The draft Interpretations proposed that the nature of the operator's asset depended on who had the primary responsibility to pay the operator for the services. The operator should recognise a financial asset when the grantor had the primary responsibility to pay the operator for the services. The operator should recognise an intangible asset in all other cases.

BC38 Respondents to the draft Interpretations argued that determining which accounting model to apply by looking at who has the primary responsibility to pay the operator for the services, irrespective of who bears demand risk (ie ability and willingness of users to pay for the service), would result in an accounting treatment that did not reflect the economic substance of the arrangement. Respondents were concerned that the proposal would require operators with essentially identical cash flow streams to adopt different accounting models. This would impair users' understanding of entities involved in providing public-to-private service concession arrangements. Several gave the example of a shadow toll road and a toll road, where the economics (demand risk) of the arrangements would be similar, pointing out that under the proposals the two arrangements would be accounted for differently. In the light of comments received on the proposals, the IFRIC decided to clarify (see paragraphs 15-19) the extent to which an operator should recognise a financial asset and an intangible asset.

BC39 Responses to the draft Interpretations provided only limited information about the impact of the proposals. To obtain additional information, IASB staff arranged for discussions with preparers, auditors and regulators. The consensus of those consulted was that the identity of the payer ~~payee~~ has no effect on the risks to the operator's cash flow stream. The operator typically relies on the terms of the service arrangement

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 requires an entity to measure non-cash consideration at fair value, unless the entity cannot reasonably estimate the fair value of the non-cash consideration. In such cases, IFRS 15 requires the entity to measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration.

contract to determine the risks to its cash flow stream. The operator's cash flows may be guaranteed by the grantor, in which case the grantor bears demand risk, or the operator's cash flows may be conditional on usage levels, in which case the operator bears demand risk.

- BC40 The IFRIC noted that the operator's cash flows are guaranteed when (a) the grantor agrees to pay the operator specified or determinable amounts whether or not the public service is used (sometimes known as take-or-pay arrangements) or (b) the grantor grants a right to the operator to charge users of the public service and the grantor guarantees the operator's cash flows by way of a shortfall guarantee described in paragraph 16. The operator's cash flows are conditional on usage when it has no such guarantee but must obtain its revenue either directly from users of the public service or from the grantor in proportion to public usage of the service (road tolls or shadow tolls for example).

A financial asset (operator's cash flows are guaranteed by the grantor)

- BC41 Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a financial asset to include 'a contractual right to receive cash or another financial asset from another entity'. Paragraph 13 of that standard clarifies that 'contractual' refers to 'an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.'
- BC42 The IFRIC decided that a financial asset should be recognised to the extent that the operator has an unconditional present right to receive cash from or at the direction of the grantor for the construction services; and the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has a contractual right to receive cash for the construction services if the grantor contractually guarantees the operator's cash flows, in the manner described in paragraph 16. The IFRIC noted that the operator has an unconditional right to receive cash to the extent that the grantor bears the risk (demand risk) that the cash flows generated by the users of the public service will not be sufficient to recover the operator's investment.
- BC43 The IFRIC noted that:
- (a) an agreement to pay for the shortfall, if any, between amounts received from users of the service and specified or determinable amounts does not meet the definition of a financial guarantee in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement** because the operator has an unconditional contractual right to receive cash from the grantor. Furthermore, the amendments made to IAS 39 in August 2005 by *Financial Guarantee Contracts* do not address the treatment of financial guarantee contracts by the holder. The objective of the amendments was to ensure that issuers of financial guarantee contracts recognise a liability for the obligations the guarantor has undertaken in issuing that guarantee.
 - (b) users or the grantor may pay the contractual amount receivable directly to the operator. The method of payment is a matter of form only. In both cases the operator has a present, unconditional, contractual right to receive the specified or determinable cash flows from or at the direction of the grantor. The nature of the operator's asset is not altered solely because the contractual amount receivable may be paid directly by users of the public service. The IFRIC observed that accounting for these contractual cash flows in accordance with IASs 32 and 39 faithfully reflects the economics of the arrangements, which is to provide finance to the operator ~~grantor~~ for the construction of the infrastructure.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Operator's cash flows are contingent on the operator meeting specified quality or efficiency requirements

- BC44 The IFRIC concluded that the definition of a financial asset is met even if the contractual right to receive cash is contingent on the operator meeting specified quality or efficiency requirements or targets. Before the grantor is required to pay the operator for its construction services, the operator may have to ensure that the infrastructure is capable of generating the public services specified by the grantor or that the infrastructure is up to or exceeds operating standards or efficiency targets specified by the grantor to ensure a specified level of service and capacity can be delivered. In this respect the operator's position is the same as that of any other entity in which payment for goods or services is contingent on subsequent performance of the goods or service sold.
- BC45 Therefore IFRIC 12 treats the consideration given by the grantor to the operator as giving rise to a financial asset irrespective of whether the contractual amounts receivable are contingent on the operator meeting levels of performance or efficiency targets.*

An intangible asset (operator's cash flows are conditional on usage)

- BC46 IAS 38 *Intangible Assets* defines an intangible asset as 'an identifiable non-monetary asset without physical substance'. It mentions licences as examples of intangible assets. It describes an asset as being identifiable when it arises from contractual rights.
- BC47 The IFRIC concluded that the right of an operator to charge users of the public service meets the definition of an intangible asset, and therefore should be accounted for in accordance with IAS 38. In these circumstances the operator's revenue is conditional on usage and it bears the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover its investment.
- BC48 In the absence of contractual arrangements designed to ensure that the operator receives a minimum amount (see paragraphs BC53 and BC54), the operator has no contractual right to receive cash even if receipt of the cash is highly probable. Rather, the operator has an opportunity to charge those who use the public service in the future. The operator bears the demand risk and hence its commercial return is contingent on users using the public service. The operator's asset is a licence, which would be classified as an intangible asset within the scope of IAS 38. And, as clarified in paragraph AG10 of the application guidance in IAS 32:

Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

- BC49 The IFRIC considered whether a right to charge users unsupported by any shortfall guarantee from the grantor could be regarded as an indirect right to receive cash arising from the contract with the grantor. It concluded that although the operator's asset might have characteristics that are similar to those of a financial asset, it would not meet the definition of a financial asset in IAS 32: the operator would not at the balance sheet date have a contractual right to receive cash from another entity. That other entity (ie the user) would still have the ability to avoid any obligation. The grantor would be passing to the operator an opportunity to charge users in future, not a present right to receive cash.

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 requires an entity to recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset. This is also discussed in paragraph 16 of IFRIC 12.

Contractual obligations to restore the infrastructure to a specified level of serviceability (paragraph 21)

- BC55 The IFRIC noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prohibits an entity from providing for the replacement of parts of its own property, plant and equipment. IAS 16 requires such costs to be recognised in the carrying amount of an item of property, plant and equipment if the recognition criteria in paragraph 7 are met. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The IFRIC concluded that this prohibition would not apply to arrangements within the scope of the Interpretation because the operator does not recognise the infrastructure as its own property, plant and equipment. The operator has an unavoidable obligation that it owes to a third party, the grantor, in respect of the infrastructure. The operator should recognise its obligations in accordance with IAS 37.
- BC56 The IFRIC considered whether the Interpretation should contain guidance on the timing of recognition of the obligations. It noted that the precise terms and circumstances of the obligations would vary from contract to contract. It concluded that the requirements and guidance in IAS 37 were sufficiently clear to enable an operator to identify the period(s) in which different obligations should be recognised.

Borrowing costs (paragraph 22)

- BC57 IAS 23 *Borrowing Costs* permits borrowing costs to be capitalised as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That Standard defines a qualifying asset as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'.
- BC58 For arrangements within the scope of the Interpretation, the IFRIC decided that an intangible asset (ie the grantor gives the operator a right to charge users of the public service in return for construction services) meets the definition of a qualifying asset of the operator because generally the licence would not be ready for use until the infrastructure was constructed or upgraded. A financial asset (ie the grantor gives the operator a contractual right to receive cash or other financial asset in return for construction services) does not meet the definition of a qualifying asset of the operator. The IFRIC observed that interest is generally accreted on the carrying value of financial assets.
- BC59 The IFRIC noted that financing arrangements may result in an operator obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure relating to construction or operation services. In such circumstances the funds are often temporarily invested. Any investment income earned on such funds is recognised in accordance with IAS 39,[#] unless the operator adopts the allowed alternative treatment, in which case investment income earned during the construction phase of the arrangement is accounted for in accordance with paragraph 16 of IAS 23.^{*,‡}

Financial asset (paragraphs 23–25)[#]

- BC60 Paragraph 9 of IAS 39 identifies and defines four categories of financial asset: (i) those held at fair value through profit or loss; (ii) held-to-maturity investments; (iii) loans and receivables; and (iv) available-for-sale financial assets.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} In March 2007, IAS 23 was revised to require the previously allowed alternative treatment of capitalisation. Therefore, an entity is required to capitalise borrowing costs as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That revision does not affect the reasoning set out in this Basis for Conclusions.

Effective for annual periods
beginning on or after 1 July 2008

HK (IFRIC) Interpretation 13

Customer Loyalty Programmes

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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HK(IFRIC) Interpretation 15

Agreements for the Construction of Real Estate

* ~~HK(IFRIC) Int 15 is applicable for annual periods beginning on or after 1 January 2009. Earlier application is permitted. HK(IFRIC) Int 15 supersedes HK Interpretation 3 issued in 2005 as revised in 2006.~~

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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Effective for annual periods
beginning on or after 1 October 2008

HK(IFRIC) Interpretation 16

Hedges of a Net Investment in a Foreign Operation



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Hong Kong (IFRIC) Interpretation 16 *Hedges of a Net Investment in a Foreign Operation* (HK(IFRIC)-Int 16) is set out in paragraphs 1–19 and the Appendix. HK(IFRIC)-Int 16 is accompanied by an illustrative example and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 16

Hedges of a Net Investment in a Foreign Operation

References

- HKFRS 9 *Financial Instruments*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 21 *The Effects of Changes in Foreign Exchange Rates*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~

Background

- 1 Many reporting entities have investments in foreign operations (as defined in HKAS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. HKAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.
- 2 Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements.* The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.
- 3 ~~HKAS 39~~HKFRS 9 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognised in other comprehensive income and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.
- 4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Interpretation provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.
- 5 ~~HKAS 39~~HKFRS 9 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.
- 6 HKAS 21 and ~~HKAS 39~~HKFRS 9 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Interpretation provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

* This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method and financial statements that include a branch or a joint operation as defined in HKFRS 11 *Joint Arrangements*.

Scope

- 7 This Interpretation applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with ~~HKAS 39~~HKFRS 9. For convenience this Interpretation refers to such an entity as a parent entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a parent entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.
- 8 This Interpretation applies only to hedges of net investments in foreign operations; it should not be applied by analogy to other types of hedge accounting.

Issues

- 9 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Interpretation are:
- (a) *the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:*
 - (i) whether the parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the parent entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the parent entity's consolidated financial statements and the functional currency of the foreign operation;
 - (ii) if the parent entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate parent entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity (ie whether the fact that the net investment in the foreign operation is held through an intermediate parent affects the economic risk to the ultimate parent).
 - (b) *where in a group the hedging instrument can be held:*
 - (i) whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency, can hold the hedging instrument;
 - (ii) whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.
 - (c) *what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation:*
 - (i) when a foreign operation that was hedged is disposed of, what amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements;
 - (ii) whether the method of consolidation affects the determination of the amounts to be reclassified from equity to profit or loss.

Conclusions

Nature of the hedged risk and amount of the hedged item for which a hedging relationship may be designated

- 10 Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency.
- 11 In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.
- 12 The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity.
- 13 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised.

Where the hedging instrument can be held

- 14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group, as long as the designation, documentation and effectiveness requirements of ~~HKAS 39~~ HKFRS 9 paragraph ~~886.4.1~~ that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the group should be clearly documented because of the possibility of different designations at different levels of the group.
- 15 For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognised in profit or loss, in other comprehensive income, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in profit or loss or in other comprehensive income. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive income. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a hedged foreign operation

- 16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount that ~~HKAS 39~~^{HKAS 21} ~~HKFRS 9~~ paragraph 1026.5.14 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.
- 17 The amount reclassified to profit or loss from the foreign currency translation reserve in the consolidated financial statements of a parent in respect of the net investment in that foreign operation in accordance with HKAS 21 paragraph 48 is the amount included in that parent's foreign currency translation reserve in respect of that foreign operation. In the ultimate parent's consolidated financial statements, the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate parent uses the direct or the step-by-step method of consolidation* may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation. The use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by HKAS 21. However, it is an accounting policy choice that should be followed consistently for all net investments.

Effective date

- 18 An entity shall apply this Interpretation for annual periods beginning on or after 1 October 2008. An entity shall apply the amendment to paragraph 14 made by *Improvements to HKFRSs* issued in May 2009 for annual periods beginning on or after 1 July 2009. Earlier application of both is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, or the amendment to paragraph 14 before 1 July 2009, it shall disclose that fact.

18A ~~[Deleted]~~

18B ~~HKFRS 9, as issued in September 2014, amended paragraphs 3, 5-7, 14, 16, AG1 and AG8 and deleted paragraph 18A. An entity shall apply those amendments when it applies HKFRS 9.~~

Transition

- 19 HKAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity had designated a hedging instrument as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in this Interpretation, the entity shall apply HKAS 39 to discontinue that hedge accounting prospectively.

* The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).

Appendix

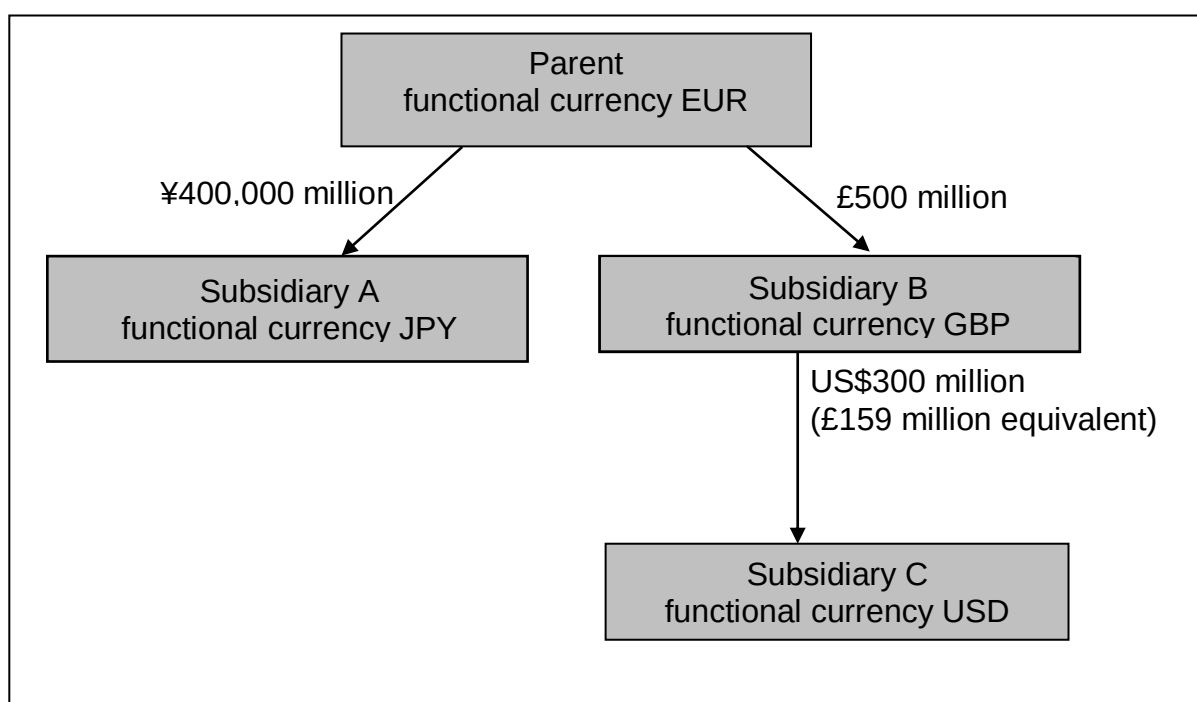
Application guidance

This appendix is an integral part of the Interpretation.

AG1 This appendix illustrates the application of the Interpretation using the corporate structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with ~~HKAS 39~~HKFRS 9, although this testing is not discussed in this appendix. Parent, being the ultimate parent entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the subsidiaries is wholly owned. Parent's £500 million net investment in Subsidiary B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Subsidiary B's US\$300 million net investment in Subsidiary C (functional currency US dollars (USD)). In other words, Subsidiary B's net assets other than its investment in Subsidiary C are £341 million.

Nature of hedged risk for which a hedging relationship may be designated (paragraphs 10–13)

AG2 Parent can hedge its net investment in each of Subsidiaries A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Parent can hedge the USD/GBP foreign exchange risk between the functional currencies of Subsidiary B and Subsidiary C. In its consolidated financial statements, Subsidiary B can hedge its net investment in Subsidiary C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Parent could designate the forward foreign exchange risk.



Amount of hedged item for which a hedging relationship may be designated (paragraphs 10–13)

- AG3 Parent wishes to hedge the foreign exchange risk from its net investment in Subsidiary C. Assume that Subsidiary A has an external borrowing of US\$300 million. The net assets of Subsidiary A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US\$300 million.
- AG4 The hedged item can be an amount of net assets equal to or less than the carrying amount of Parent's net investment in Subsidiary C (US\$300 million) in its consolidated financial statements. In its consolidated financial statements Parent can designate the US\$300 million external borrowing in Subsidiary A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US\$300 million net assets of Subsidiary C. In this case, both the EUR/USD foreign exchange difference on the US\$300 million external borrowing in Subsidiary A and the EUR/USD foreign exchange difference on the US\$300 million net investment in Subsidiary C are included in the foreign currency translation reserve in Parent's consolidated financial statements after the application of hedge accounting.
- AG5 In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Subsidiary A would be recognised in Parent's consolidated financial statements as follows:
- USD/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
 - JPY/EUR spot foreign exchange rate change in other comprehensive income.

Instead of the designation in paragraph AG4, in its consolidated financial statements Parent can designate the US\$300 million external borrowing in Subsidiary A as a hedge of the GBP/USD spot foreign exchange risk between Subsidiary C and Subsidiary B. In this case, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Subsidiary A would instead be recognised in Parent's consolidated financial statements as follows:

- the GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Subsidiary C,
 - GBP/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
 - JPY/EUR spot foreign exchange rate change in other comprehensive income.
- AG6 Parent cannot designate the US\$300 million external borrowing in Subsidiary A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Subsidiary B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the group comprising Subsidiary B and Subsidiary C.

Where in a group can the hedging instrument be held (paragraphs 14 and 15)?

- AG7 As noted in paragraph AG5, the total change in value in respect of foreign exchange risk of the US\$300 million external borrowing in Subsidiary A would be recorded in both profit or loss (USD/JPY spot risk) and other comprehensive income (EUR/JPY spot risk) in Parent's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph AG4 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Parent against the US dollar functional currency of Subsidiary C, in accordance with the hedge documentation. The method of

consolidation (ie direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts reclassified to profit or loss on disposal of a foreign operation (paragraphs 16 and 17)

- AG8 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:
- (a) in respect of the US\$300 million external borrowing of Subsidiary A, the amount that ~~HKAS 39~~HKFRS 9 requires to be identified, ie the total change in value in respect of foreign exchange risk that was recognised in other comprehensive income as the effective portion of the hedge; and
 - (b) in respect of the US\$300 million net investment in Subsidiary C, the amount determined by the entity's consolidation method. If Parent uses the direct method, its FCTR in respect of Subsidiary C will be determined directly by the EUR/USD foreign exchange rate. If Parent uses the step-by-step method, its FCTR in respect of Subsidiary C will be determined by the FCTR recognised by Subsidiary B reflecting the GBP/USD foreign exchange rate, translated to Parent's functional currency using the EUR/GBP foreign exchange rate. Parent's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of Subsidiary C to be the amount that it would have recognised if it had always used the direct method, depending on its accounting policy.

Hedging more than one foreign operation (paragraphs 11, 13 and 15)

- AG9 The following examples illustrate that in the consolidated financial statements of Parent, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Subsidiaries B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Parent's consolidated financial statements when both foreign operations are hedged are US\$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Parent's consolidated profit or loss. Of course, it would be possible for Parent to designate US\$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Parent holds both USD and GBP hedging instruments

- AG10 Parent may wish to hedge the foreign exchange risk in relation to its net investment in Subsidiary B as well as that in relation to Subsidiary C. Assume that Parent holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Subsidiary B and Subsidiary C. The designations Parent can make in its consolidated financial statements include, but are not limited to, the following:
- (a) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (EUR/USD) between Parent and Subsidiary C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.
 - (b) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.

- AG11 The EUR/USD risk from Parent's net investment in Subsidiary C is a different risk from the EUR/GBP risk from Parent's net investment in Subsidiary B. However, in the case described in paragraph AG10(a), by its designation of the USD hedging instrument it holds, Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C. If Parent also designated a GBP instrument it holds as a hedge of its £500 million net investment in Subsidiary B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Subsidiary C, would be hedged twice for GBP/EUR risk in Parent's consolidated financial statements.
- AG12 In the case described in paragraph AG10(b), if Parent designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C, only the GBP/USD part of the change in the value of its US\$300 million hedging instrument is included in Parent's foreign currency translation reserve relating to Subsidiary C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Parent's consolidated profit or loss, as in paragraph AG5. Because the designation of the USD/GBP risk between Subsidiaries B and C does not include the GBP/EUR risk, Parent is also able to designate up to £500 million of its net investment in Subsidiary B with the risk being the spot foreign exchange exposure (GBP/EUR) between Parent and Subsidiary B.

Subsidiary B holds the USD hedging instrument

- AG13 Assume that Subsidiary B holds US\$300 million of external debt, the proceeds of which were transferred to Parent by an inter-company loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Subsidiary B's net assets are unchanged. Subsidiary B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Subsidiary C in its consolidated financial statements. Parent could maintain Subsidiary B's designation of that hedging instrument as a hedge of its US\$300 million net investment in Subsidiary C for the GBP/USD risk (see paragraph 13) and Parent could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Subsidiary B. The first hedge, designated by Subsidiary B, would be assessed by reference to Subsidiary B's functional currency (pounds sterling) and the second hedge, designated by Parent, would be assessed by reference to Parent's functional currency (euro). In this case, only the GBP/USD risk from Parent's net investment in Subsidiary C has been hedged in Parent's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Parent's £500 million net investment in Subsidiary B may be hedged in the consolidated financial statements of Parent.
- AG14 However, the accounting for Parent's £159 million loan payable to Subsidiary B must also be considered. If Parent's loan payable is not considered part of its net investment in Subsidiary B because it does not satisfy the conditions in HKAS 21 paragraph 15, the GBP/EUR foreign exchange difference arising on translating it would be included in Parent's consolidated profit or loss. If the £159 million loan payable to Subsidiary B is considered part of Parent's net investment, that net investment would be only £341 million and the amount Parent could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.
- AG15 If Parent reversed the hedging relationship designated by Subsidiary B, Parent could designate the US\$300 million external borrowing held by Subsidiary B as a hedge of its US\$300 million net investment in Subsidiary C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Subsidiary B. In this case the effectiveness of both hedges would be computed by reference to Parent's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Subsidiary B and the GBP/EUR change in value of Parent's loan payable to Subsidiary B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Parent's consolidated financial statements. Because Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Subsidiary B.

Illustrative example

This example accompanies, but is not part of, IFRIC 16.

Disposal of a foreign operation (paragraphs 16 and 17)

- IE1 This example illustrates the application of paragraphs 16 and 17 in connection with the reclassification adjustment on the disposal of a foreign operation.

Background

- IE2 This example assumes the group structure set out in the application guidance and that Parent used a USD borrowing in Subsidiary A to hedge the EUR/USD risk of the net investment in Subsidiary C in Parent's consolidated financial statements. Parent uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Subsidiary C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Subsidiary C, when measured against the functional currency of Parent (euro).
- IE3 If the direct method of consolidation is used, the fall in the value of Parent's net investment in Subsidiary C of €24 million would be reflected totally in the foreign currency translation reserve relating to Subsidiary C in Parent's consolidated financial statements. However, because Parent uses the step-by-step method, this fall in the net investment value in Subsidiary C of €24 million would be reflected both in Subsidiary B's foreign currency translation reserve relating to Subsidiary C and in Parent's foreign currency translation reserve relating to Subsidiary B.
- IE4 The aggregate amount recognised in the foreign currency translation reserve in respect of Subsidiaries B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Subsidiaries B and C in Parent's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

- IE5 When the investment in Subsidiary C is disposed of, ~~IAS 39~~ IFRS 9 requires the full €24 million gain on the hedging instrument to be reclassified to profit or loss. Using the step-by-step method, the amount to be reclassified to profit or loss in respect of the net investment in Subsidiary C would be only €11 million loss. Parent could adjust the foreign currency translation reserves of both Subsidiaries B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting policy. An entity that had not hedged its net investment could make the same reclassification.

Basis for Conclusions on IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*

This Basis for Conclusions accompanies, but is not part of, IFRIC 16.

HK(IFRIC)-Int 16 is based on IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*. In approving HK(IFRIC)-Int 16, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 16. Accordingly, there are no significant differences between HK(IFRIC)-Int 16 and IFRIC Interpretation 16. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 16 referred to below generally correspond with those in HK(IFRIC)-Int 16.

Introduction

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

- BC2 The IFRIC was asked for guidance on accounting for the hedge of a net investment in a foreign operation in the consolidated financial statements. Interested parties had different views of the risks eligible for hedge accounting purposes. One issue is whether the risk arises from the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or whether it arises from the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the parent entity's consolidated financial statements.
- BC3 Concern was also raised about which entity within a group could hold a hedging instrument in a hedge of a net investment in a foreign operation and in particular whether the parent entity holding the net investment in a foreign operation must also hold the hedging instrument.
- BC4 Accordingly, the IFRIC decided to develop guidance on the accounting for a hedge of the foreign currency risk arising from a net investment in a foreign operation.
- BC5 The IFRIC published draft Interpretation D22 *Hedges of a Net Investment in a Foreign Operation* for public comment in July 2007 and received 45 comment letters in response to its proposals.

Consensus

Hedged risk and hedged item

Functional currency versus presentation currency (paragraph 10)

- BC6 The IFRIC received a submission suggesting that the method of consolidation can affect the determination of the hedged risk in a hedge of a net investment in a foreign operation. The submission noted that consolidation can be completed by either the direct method or the step-by-step method. In the direct method of consolidation, each entity within a group is consolidated directly into the ultimate parent entity's presentation currency when preparing the consolidated financial statements. In the step-by-step method, each intermediate parent entity prepares consolidated financial statements, which are then consolidated into its parent entity until the ultimate parent entity has prepared consolidated financial statements.
- BC7 The submission stated that if the direct method was required, the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation would arise only from

exposure between the functional currency of the foreign operation and the presentation currency of the group. This is because each foreign operation is translated only once into the presentation currency. In contrast, the submission stated that if the step-by-step method was required, the hedged risk that qualifies for hedge accounting is the risk between the functional currencies of the foreign operation and the immediate parent entity into which the entity was consolidated. This is because each foreign operation is consolidated directly into its immediate parent entity.

- BC8 In response to this, the IFRIC noted that IAS 21 *The Effects of Changes in Foreign Exchange Rates* does not specify a method of consolidation for foreign operations. Furthermore, paragraph BC18 of the Basis for Conclusions on IAS 21 states that the method of translating financial statements will result in the same amounts in the presentation currency regardless of whether the direct method or the step-by-step method is used. The IFRIC therefore concluded that the consolidation mechanism should not determine what risk qualifies for hedge accounting in the hedge of a net investment in a foreign operation.
- BC9 However, the IFRIC noted that its conclusion would not resolve the divergence of views on the foreign currency risk that may be designated as a hedge relationship in the hedge of a net investment in a foreign operation. The IFRIC therefore decided that an Interpretation was needed.
- BC10 The IFRIC considered whether the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation arises from the exposure to the functional currency of the foreign operation in relation to the presentation currency of the group or the functional currency of the parent entity, or both.
- BC11 The answer to this question is important when the presentation currency of the group is different from an intermediate or ultimate parent entity's functional currency. If the presentation currency of the group and the functional currency of the parent entity are the same, the exchange rate being hedged would be identified as that between the parent entity's functional currency and the foreign operation's functional currency. No further translation adjustment would be required to prepare the consolidated financial statements. However, when the functional currency of the parent entity is different from the presentation currency of the group, a translation adjustment will be included in other comprehensive income to present the consolidated financial statements in a different presentation currency. The issue, therefore, is how to determine which foreign currency risk may be designated as the hedged risk in accordance with IAS 39 *Financial Instruments: Recognition and Measurement** in the hedge of a net investment in a foreign operation.
- BC12 The IFRIC noted the following arguments for permitting hedge accounting for a hedge of the presentation currency:
- (a) If the presentation currency of the group is different from the ultimate parent entity's functional currency, a difference arises on translation that is recognised in other comprehensive income. It is argued that a reason for allowing hedge accounting for a net investment in a foreign operation is to remove from the financial statements the fluctuations resulting from the translation to a presentation currency. If an entity is not allowed to use hedge accounting for the exposure to the presentation currency of the group when it is different from the functional currency of the parent entity, there is likely to be an amount included in other comprehensive income that cannot be offset by hedge accounting.
 - (b) IAS 21 requires an entity to reclassify from equity to profit or loss as a reclassification adjustment any foreign currency translation gains and losses included in other comprehensive income on disposal of a foreign operation. An amount in other comprehensive income arising from a different presentation currency is therefore included in the amount reclassified to profit or loss on disposal. The entity should be able to include the amount in a hedging relationship if at some stage it is recognised along with other reclassified translation amounts.

* IFRS 9 *Financial Instruments* replaced the hedge accounting requirements in IAS 39. However, the requirements regarding hedges of a net investment in a foreign operation were retained from IAS 39 and relocated to IFRS 9.

BC13 The IFRIC noted the following arguments for allowing an entity to designate hedging relationships solely on the basis of differences between functional currencies:

- (a) The functional currency of an entity is determined on the basis of the primary economic environment in which that entity operates (ie the environment in which it generates and expends cash). However, the presentation currency is an elective currency that can be changed at any time. To present amounts in a presentation currency is merely a numerical convention necessary for the preparation of financial statements that include a foreign operation. The presentation currency will have no economic effect on the parent entity. Indeed, a parent entity may choose to present financial statements in more than one presentation currency, but can have only one functional currency.
- (b) IAS 39 requires a hedging relationship to be effective in offsetting changes in fair values or cash flows attributable to the hedged risk. A net investment in a foreign operation gives rise to an exposure to changes in exchange rate risk for a parent entity. An economic exchange rate risk arises only from an exposure between two or more functional currencies, not from a presentation currency.

BC14 When comparing the arguments in paragraphs BC12 and BC13, the IFRIC concluded that the presentation currency does not create an exposure to which an entity may apply hedge accounting. The functional currency is determined on the basis of the primary economic environment in which the entity operates. Accordingly, functional currencies create an economic exposure to changes in cash flows or fair values; a presentation currency never will. No commentators on the draft Interpretation disagreed with the IFRIC's conclusion.

Eligible risk (paragraph 12)

BC15 The IFRIC considered which entity's (or entities') functional currency may be used as a reference point for the hedged risk in a net investment hedge. Does the risk arise from the functional currency of:

- (a) the immediate parent entity that holds directly the foreign operation;
- (b) the ultimate parent entity that is preparing its financial statements; or
- (c) the immediate, an intermediate or the ultimate parent entity, depending on what risk that entity decides to hedge, as designated at the inception of the hedge?

BC16 The IFRIC concluded that the risk from the exposure to a different functional currency arises for any parent entity whose functional currency is different from that of the identified foreign operation. The immediate parent entity is exposed to changes in the exchange rate of its directly held foreign operation's functional currency. However, indirectly every entity up the chain of entities to the ultimate parent entity is also exposed to changes in the exchange rate of the foreign operation's functional currency.

BC17 Permitting only the ultimate parent entity to hedge its net investments would ignore the exposures arising on net investments in other parts of the entity. Conversely, permitting only the immediate parent entity to undertake a net investment hedge would imply that an indirect investment does not create a foreign currency exposure for that indirect parent entity.

BC18 The IFRIC concluded that a group must identify which risk (ie the functional currency of which parent entity and of which net investment in a foreign operation) is being hedged. The specified parent entity, the hedged risk and hedging instrument should all be designated and documented at the inception of the hedge relationship. As a result of comments received on the draft Interpretation, the IFRIC decided to emphasise that this documentation should also include the entity's strategy in undertaking the hedge as required by IAS 39.

Amount of hedged item that may be hedged (paragraphs 11 and 13)

- BC19 In the draft Interpretation the IFRIC noted that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. This comment was intended to remind entities that IAS 39 does not permit multiple hedges of the same risk. Some respondents asked the IFRIC to clarify the situations in which the IFRIC considered that the same risk was being hedged more than once. In particular, the IFRIC was asked whether the same risk could be hedged by different entities within a group as long as the amount of risk being hedged was not duplicated.
- BC20 In its redeliberations, the IFRIC decided to clarify that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements. An intermediate parent entity can hedge some or all of the risk of its net investment in a foreign operation in its own consolidated financial statements. However, such hedges will not qualify for hedge accounting at the ultimate parent entity level if the ultimate parent entity has also hedged the same risk. Alternatively, if the risk has not been hedged by the ultimate parent entity or another intermediate parent entity, the hedge relationship that qualified in the immediate parent entity's consolidated financial statements will also qualify in the ultimate parent entity's consolidated financial statements.
- BC21 In its redeliberations, the IFRIC also decided to add guidance to the Interpretation to illustrate the importance of careful designation of the amount of the risk being hedged by each entity in the group.

Hedging instrument**Location of the hedging instrument (paragraph 14) and assessment of hedge effectiveness (paragraph 15)**

- BC22 The IFRIC discussed where in a group structure a hedging instrument may be held in a hedge of a net investment in a foreign operation. Guidance on the hedge of a net investment in a foreign operation was originally included in IAS 21. This guidance was moved to IAS 39 to ensure that the hedge accounting guidance included in paragraph 88 of IAS 39 would also apply to the hedges of net investments in foreign operations.
- BC23 The IFRIC concluded that any entity within the group, other than the foreign operation being hedged, may hold the hedging instrument, as long as the hedging instrument is effective in offsetting the risk arising from the exposure to the functional currency of the foreign operation and the functional currency of the specified parent entity. The functional currency of the entity holding the instrument is irrelevant in determining effectiveness.
- BC24 ~~The IFRIC concluded that the foreign operation being hedged could not hold the hedging instrument because that instrument would be part of, and denominated in the same currency as, the net investment it was intended to hedge. In this circumstance, hedge accounting is unnecessary. The foreign exchange differences between the parent's functional currency and both the hedging instrument and the functional currency of the net investment will automatically be included in the group's foreign currency translation reserve as part of the consolidation process. The balance of the discussion in this Basis for Conclusions does not repeat this restriction.*~~
- BC24A Paragraph 14 of IFRIC 16 originally stated that the hedging instrument could not be held by the foreign operation whose net investment was being hedged. The restriction was included in draft Interpretation D22 (from which IFRIC 16 was developed) and attracted little comment from respondents. As originally explained in paragraph BC24, the IFRIC concluded, as part of

* Paragraph BC24 was deleted and paragraphs BC24A-BC24D and paragraph BC40A added as a consequence of *Improvements to IFRSs* issued in April 2009.

its redeliberations, that the restriction was appropriate because the foreign exchange differences between the parent's functional currency and both the hedging instrument and the functional currency of the net investment would automatically be included in the group's foreign currency translation reserve as part of the consolidation process.

BC24B After IFRIC 16 was issued, it was brought to the attention of the International Accounting Standards Board that this conclusion was not correct. Without hedge accounting, part of the foreign exchange difference arising from the hedging instrument would be included in consolidated profit or loss. Therefore, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 14 of IFRIC 16 to remove the restriction on the entity that can hold hedging instruments and deleted paragraph BC24.

BC24C Some respondents to the exposure draft *Post-implementation Revisions to IFRIC Interpretations* (ED/2009/1) agreed that a parent entity should be able to use a derivative held by the foreign operation being hedged as a hedge of the net investment in that foreign operation. However, those respondents recommended that the amendment should apply only to derivative instruments held by the foreign operation being hedged. They asserted that a non-derivative financial instrument would be an effective hedge of the net investment only if it were issued by the foreign operation in its own functional currency and this would have no foreign currency impact on the profit or loss of the consolidated group. Consequently, they thought that the rationale described in paragraph BC24B to support the amendment did not apply to non-derivative instruments.

BC24D In its redeliberations, the Board confirmed its previous decision that the amendment should not be restricted to derivative instruments. The Board noted that paragraphs AG13–AG15 of IFRIC 16 illustrate that a non-derivative instrument held by the foreign operation does not need to be considered to be part of the parent's net investment. As a result, even if it is denominated in the foreign operation's functional currency a non-derivative instrument could still affect the profit or loss of the consolidated group. Consequently, although it could be argued that the amendment was not required to permit non-derivative instruments to be designated as hedges, the Board decided that the proposal should not be changed.

BC25 The IFRIC also concluded that to apply the conclusion in paragraph BC23 when determining the effectiveness of a hedging instrument in the hedge of a net investment, an entity computes the gain or loss on the hedging instrument by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge documentation. This is the same regardless of the type of hedging instrument used. This ensures that the effectiveness of the instrument is determined on the basis of changes in fair value or cash flows of the hedging instrument, compared with the changes in the net investment as documented. Thus, any effectiveness test is not dependent on the functional currency of the entity holding the instrument. In other words, the fact that some of the change in the hedging instrument is recognised in profit or loss by one entity within the group and some is recognised in other comprehensive income by another does not affect the assessment of hedge effectiveness.

BC26 In the draft Interpretation the IFRIC noted Question F.2.14 in the guidance on implementing IAS 39, on the location of the hedging instrument, and considered whether that guidance could be applied by analogy to a net investment hedge. The answer to Question F.2.14 concludes:

IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

This was the only basis for the IFRIC's conclusion regarding which entity could hold the hedging instrument provided in the draft Interpretation. Some respondents argued that the Interpretation should not refer to implementation guidance as the sole basis for an important conclusion.²

* IFRS 9 replaced IAS 39.

- BC27 In its redeliberations, the IFRIC considered both the International Accounting Standards Board's amendment to IAS 21 in 2005 and the objective of hedging a net investment described in IAS 39 in addition to the guidance on implementing IAS 39.
- BC28 In 2005 the Board was asked to clarify which entity is the reporting entity in IAS 21 and therefore what instruments could be considered part of a reporting entity's net investment in a foreign operation. In particular, constituents questioned whether a monetary item must be transacted between the foreign operation and the reporting entity to be considered part of the net investment in accordance with IAS 21 paragraph 15, or whether it could be transacted between the foreign operation and any member of the consolidated group.
- BC29 In response the Board added IAS 21 paragraph 15A to clarify that, 'The entity that has a monetary item receivable from or payable to a foreign operation described in paragraph 15 may be any subsidiary of the group.' The Board explained its reasons for the amendment in paragraph BC25D of the Basis for Conclusions:

The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor on which entity within the group conducts the transaction with the foreign operation.

In other words, the Board concluded that the relevant reporting entity is the group rather than the individual entity and that the net investment must be viewed from the perspective of the group. It follows, therefore, that the group's net investment in any foreign operation, and its foreign currency exposure, can be determined only at the relevant parent entity level. The IFRIC similarly concluded that the fact that the net investment is held through an intermediate entity does not affect the economic risk.

- BC30 Consistently with the Board's conclusion with respect to monetary items that are part of *the net investment*, the IFRIC concluded that monetary items (or derivatives) that are *hedging instruments* in a hedge of a net investment may be held by any entity within the group and the functional currency of the entity holding the monetary items can be different from those of either the parent or the foreign operation. The IFRIC, like the Board, agreed with constituents who noted that a hedging item denominated in a currency that is not the functional currency of the entity holding it does not expose the group to a greater foreign currency exchange difference than arises when the instrument is denominated in that functional currency.
- BC31 The IFRIC noted that its conclusions that the hedging instrument can be held by any entity in the group and that the foreign currency is determined at the relevant parent entity level have implications for the designation of hedged risks. As illustrated in paragraph AG5 of the application guidance, these conclusions make it possible for an entity to designate a hedged risk that is not apparent in the currencies of the hedged item or the foreign operation. This possibility is unique to hedges of net investments. Consequently, the IFRIC specified that the conclusions in the Interpretation should not be applied by analogy to other types of hedge accounting.
- BC32 The IFRIC also noted that the objective of hedge accounting as set out in IAS 39 is to achieve offsetting changes in the values of the *hedging instrument* and of the *net investment* attributable to the hedged risk. Changes in foreign currency rates affect the value of the entire *net investment* in a foreign operation, not only the portion IAS 21 requires to be recognised in profit or loss in the absence of hedge accounting but also the portion recognised in other comprehensive income in the parent's consolidated financial statements. As noted in paragraph BC25, it is the total change in the hedging instrument as result of a change in the foreign currency rate with respect to the parent entity against whose functional currency the hedged risk is measured that is relevant, not the component of comprehensive income in which it is recognised.

Reclassification from other comprehensive income to profit or loss (paragraphs 16 and 17)

- BC33 In response to requests from some respondents for clarification, the IFRIC discussed what amounts from the parent entity's foreign currency translation reserve in respect of both the hedging instrument and the foreign operation should be recognised in profit or loss in the parent entity's consolidated financial statements when the parent disposes of a foreign operation that was hedged. The IFRIC noted that the amounts to be reclassified from equity to profit or loss as reclassification adjustments on the disposition are:
- (a) the cumulative amount of gain or loss on a hedging instrument determined to be an effective hedge that has been reflected in other comprehensive income (IAS 39 paragraph 102), and
 - (b) the cumulative amount reflected in the foreign currency translation reserve in respect of that foreign operation (IAS 21 paragraph 48).
- BC34 The IFRIC noted that when an entity hedges a net investment in a foreign operation, IAS 39 requires it to identify the cumulative amount included in the group's foreign currency translation reserve as a result of applying hedge accounting, ie the amount determined to be an effective hedge. Therefore, the IFRIC concluded that when a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument in the consolidated financial statements of the parent should be the amount that IAS 39 requires to be identified.

Effect of consolidation method

- BC35 Some respondents to the draft Interpretation argued that the method of consolidation creates a difference in the amounts included in the ultimate parent entity's foreign currency translation reserve for individual foreign operations that are held through intermediate parents. These respondents noted that this difference may become evident only when the ultimate parent entity disposes of a second tier subsidiary (ie an indirect subsidiary).
- BC36 The difference becomes apparent in the determination of the amount of the foreign currency translation reserve that is subsequently reclassified to profit or loss. An ultimate parent entity using the direct method of consolidation would reclassify the cumulative foreign currency translation reserve that arose between its functional currency and that of the foreign operation. An ultimate parent entity using the step-by-step method of consolidation might reclassify the cumulative foreign currency translation reserve reflected in the financial statements of the intermediate parent, ie the amount that arose between the functional currency of the foreign operation and that of the intermediate parent, translated into the functional currency of the ultimate parent.
- BC37 In its redeliberations, the IFRIC noted that the use of the step-by-step method of consolidation does create such a difference for an *individual* foreign operation although the aggregate net amount of foreign currency translation reserve for all the foreign operations is the same under either method of consolidation. At the same time, the IFRIC noted that the method of consolidation *should not* create such a difference for an individual foreign operation, on the basis of its conclusion that the economic risk is determined in relation to the ultimate parent's functional currency.
- BC38 The IFRIC noted that the amount of foreign currency translation reserve for an individual foreign operation determined by the direct method of consolidation reflects the economic risk between the functional currency of the foreign operation and that of the ultimate parent (if the parent's functional and presentation currencies are the same). However, the IFRIC noted that IAS 21 does not require an entity to use this method or to make adjustments to produce the same result. The IFRIC also noted that a parent entity is not precluded from determining the amount of the foreign currency translation reserve in respect of a foreign operation it has disposed of as if the direct method of consolidation had been used in order to reclassify the

appropriate amount to profit or loss. However, it also noted that making such an adjustment on the disposal of a foreign operation is an accounting policy choice and should be followed consistently for the disposal of all net investments.

- BC39 The IFRIC noted that this issue arises when the net investment disposed of was not hedged and therefore is not strictly within the scope of the Interpretation. However, because it was a topic of considerable confusion and debate, the IFRIC decided to include a brief example illustrating its conclusions.

Transition (paragraph 19)

- BC40 In response to respondents' comments, the IFRIC clarified the Interpretation's transitional requirements. The IFRIC decided that entities should apply the conclusions in this Interpretation to existing hedging relationships on adoption and cease hedge accounting for those that no longer qualify. However, previous hedge accounting is not affected. This is similar to the transition requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* paragraph 30,* for relationships accounted for as hedges under previous GAAP.

Effective date of amended paragraph 14

- BC40A The Board amended paragraph 14 in April 2009. In ED/2009/01 the Board proposed that the amendment should be effective for annual periods beginning on or after 1 October 2008, at the same time as IFRIC 16. Respondents to the exposure draft were concerned that permitting application before the amendment was issued might imply that an entity could designate hedge relationships retrospectively, contrary to the requirements of IAS 39. Consequently, the Board decided that an entity should apply the amendment to paragraph 14 made in April 2009 for annual periods beginning on or after 1 July 2009. The Board also decided to permit early application but noted that early application is possible only if the designation, documentation and effectiveness requirements of paragraph 88 of IAS 39 and of IFRIC 16 are satisfied at the application date.

Summary of main changes from the draft Interpretation

- BC41 The main changes from the IFRIC's proposals are as follows:
- (a) Paragraph 11 clarifies that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.
 - (b) Paragraph 15 clarifies that the assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.
 - (c) Paragraphs 16 and 17 and the illustrative example clarify what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation.
 - (d) Paragraph 19 clarifies transitional requirements.
 - (e) The appendix of application guidance was added to the Interpretation. Illustrative examples accompanying the draft Interpretation were removed.

* Paragraph B6 in the revised version of IFRS 1 issued in November 2008.

- (f) The Basis for Conclusions was changed to set out more clearly the reasons for the IFRIC's conclusions.

Effective for annual periods
beginning on or after 1 July 2009

HK(IFRIC) Interpretation 17

Distributions of Non-cash Assets to Owners



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How should an entity measure a dividend payable? (paragraphs 11–13)

- BC21 IFRSs do not provide guidance on how an entity should measure distributions to owners. However, the IFRIC noted that a number of IFRSs address how a liability should be measured. Although IFRSs do not specifically address how an entity should measure a dividend payable, the IFRIC decided that it could identify potentially relevant IFRSs and apply their principles to determine the appropriate measurement basis.

Which IFRSs are relevant to the measurement of a dividend payable?

- BC22 The IFRIC considered all IFRSs that prescribe the accounting for a liability. Of those, the IFRIC concluded that IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* and IAS 39 *Financial Instruments: Recognition and Measurement*^{*} were the most likely to be relevant. The IFRIC concluded that other IFRSs were not applicable because most of them addressed only liabilities arising from exchange transactions and some of them were clearly not relevant (eg IAS 12 *Income Taxes*). As mentioned above, the Interpretation addresses only non-reciprocal distributions of assets by an entity to its owners.
- BC23 Given that all types of distributions have the purpose of distributing assets to owners, the IFRIC decided that all dividends payable should be measured the same way, regardless of the types of assets to be distributed. This also ensures that all dividends payable are measured consistently.
- BC24 Some believed that IAS 39 was the appropriate IFRS to be used to measure dividends payable. They believed that, once an entity declared a distribution to its owners, it had a contractual obligation to distribute the assets to its owners. However, IAS 39 would not cover dividends payable if they were considered to be non-contractual obligations. In addition, IAS 39 covers some but not all obligations that require an entity to deliver non-cash assets to another entity. It does not cover a liability to distribute non-financial assets to owners. The IFRIC therefore concluded that it was not appropriate to conclude that all dividends payable should be within the scope of IAS 39.
- BC25 The IFRIC then considered IAS 37, which is generally applied in practice to determine the accounting for liabilities other than those arising from executory contracts and those addressed by other IFRSs. IAS 37 requires an entity to measure a liability on the basis of the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Consequently, in D23 the IFRIC decided that it was appropriate to apply the principles in IAS 37 to all dividends payable (regardless of the types of assets to be distributed). The IFRIC decided that to apply IAS 37 to measure a liability for an obligation to distribute non-cash assets to owners, an entity should consider the fair value of the assets to be distributed. The fair value of the assets to be distributed is clearly relevant no matter which approach in IAS 37 is taken to determine the best estimate of the expenditure required to settle the liability.
- BC26 However, in response to comments received on D23, the IFRIC reconsidered whether the Interpretation should specify that all dividends payable should be measured in accordance with IAS 37. The IFRIC noted that many respondents were concerned that D23 might imply that the measurement attribute in IAS 37 should always be interpreted to be fair value. This was not the intention of D23 as that question is part of the Board's project to amend IAS 37. In addition, many respondents were not certain whether measuring the dividend payable 'by reference to' the fair value of the assets to be distributed required measurement at their fair value or at some other amount.
- BC27 Therefore, the IFRIC decided to modify the proposal in D23 to require the dividend payable to be measured at the fair value of the assets to be distributed, without linking to any individual standard its conclusion that fair value is the most relevant measurement attribute. The IFRIC also noted that if the assets being distributed constituted a business, its fair value could be different from the simple sum of the fair value of the component assets and liabilities (ie it includes the value of goodwill or the identified intangible assets).

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Should any exception be made to the principle of measuring a dividend payable at the fair value of the assets to be distributed?

- BC28 Some are concerned that the fair value of the assets to be distributed might not be reliably measurable in all cases. They believe that exceptions should be made in the following circumstances:
- (a) An entity distributes an ownership interest of another entity that is not traded in an active market and the fair value of the ownership interest cannot be measured reliably. The IFRIC noted that IAS 39^v does not permit investments in equity instruments that do not have a quoted market price in an active market* and whose fair value cannot be measured reliably to be measured at fair value.
 - (b) An entity distributes an intangible asset that is not traded in an active market and therefore would not be permitted to be carried at a revalued amount in accordance with IAS 38 *Intangible Assets*.
- BC29 The IFRIC noted that in accordance with IAS 39 paragraphs AG80 and AG81,^α the fair value of equity instruments that do not have a quoted price in an active market[†] is reliably measurable if:
- (a) the variability in the range of reasonable fair value estimates is not significant for that instrument, or
 - (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- BC30 The IFRIC noted that, when the management of an entity recommends a distribution of a non-cash asset to its owners, one or both of the conditions for determining a reliable measure of the fair value of equity instruments that do not have a quoted price in an active market is likely to be satisfied. Management would be expected to know the fair value of the asset because management has to ensure that all owners of the entity are informed of the value of the distribution. For this reason, it would be difficult to argue that the fair value of the assets to be distributed cannot be determined reliably.
- BC31 In addition, the IFRIC recognised that in some cases the fair value of an asset must be estimated. As mentioned in paragraph 86 of the *Framework for the Preparation and Presentation of Financial Statements*[#], the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

^v IFRS 9 *Financial Instruments* requires all investments in equity instruments to be measured at fair value.

* IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result ~~IFRS 9~~ IAS 39 refers to ~~such unquoted~~ equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

^α ~~IFRS 9 *Financial Instruments* deleted paragraphs AG80 and AG81 of IAS 39. IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9~~ IAS 39 refers to ~~such unquoted~~ equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

[†] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result ~~IFRS 9~~ IAS 39 refers to ~~such unquoted~~ equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

[#] now paragraph 4.1 of the *Conceptual Framework*. References to the *Framework* are to IASB's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- BC32 The IFRIC noted that a reason why IAS 38 and IAS 39* require some assets to be measured using a historical cost basis is cost-benefit considerations. The cost of determining the fair value of an asset not traded in an active market at the end of each reporting period could outweigh the benefits. However, because an entity would be required to determine the fair value of the assets to be distributed only once at the time of distribution, the IFRIC concluded that the benefit (ie informing users of the financial statements of the value of the assets distributed) outweighs the cost of determining the fair value of the assets.

* IFRS 9 *Financial Instruments* eliminated the requirement in IAS 39 for some assets to be measured using a historical cost basis.

- BC33 Furthermore, the IFRIC noted that dividend income, regardless of whether it is in the form of cash or non-cash assets, is within the scope of IAS 18 *Revenue*^{*} and is required to be measured at the fair value of the consideration received. Although the Interpretation does not address the accounting by the recipient of the non-cash distribution, the IFRIC concluded that the Interpretation did not impose a more onerous requirement on the entity that makes the distribution than IFRSs have already imposed on the recipient of the distribution.
- BC34 For the reasons described in paragraphs BC28–BC33, the IFRIC concluded that no exceptions should be made to the requirement that the fair value of the asset to be distributed should be used in measuring a dividend payable.

Whether an entity should remeasure the dividend payable (paragraph 13)

- BC35 The IFRIC noted that paragraph 59 of IAS 37 requires an entity to review the carrying amount of a liability at the end of each reporting period and to adjust the carrying amount to reflect the current best estimate of the liability. Other IFRSs such as IAS 19 *Employee Benefits* similarly require liabilities that are based on estimates to be adjusted each reporting period. The IFRIC therefore decided that the entity should review and adjust the carrying amount of the dividend payable to reflect its current best estimate of the fair value of the assets to be distributed at the end of each reporting period and at the date of settlement.
- BC36 The IFRIC concluded that, because any adjustments to the best estimate of the dividend payable reflect changes in the estimated value of the distribution, they should be recognised as adjustments to the amount of the distribution. In accordance with IAS 1 *Presentation of Financial Statements* (as revised in 2007), distributions to owners are required to be recognised directly in the statement of changes in equity. Similarly, adjustments to the amount of the distribution are also recognised directly in the statement of changes in equity.
- BC37 Some commentators argued that the changes in the estimated value of the distribution should be recognised in profit or loss because changes in liabilities meet the definition of income or expenses in the *Framework*. However, the IFRIC decided that the gain or loss on the assets to be distributed should be recognised in profit or loss when the dividend payable is settled. This is consistent with other IFRSs (IAS 16, IAS 38, IAS 39[#]) that require an entity to recognise in profit or loss any gain or loss arising from derecognition of an asset. The IFRIC concluded that the changes in the dividend payable before settlement related to changes in the estimate of the distribution and should be accounted for in equity (ie adjustments to the amount of the distribution) until settlement of the dividend payable.

When the entity settles the dividend payable, how should it account for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable? (paragraph 14)

- BC38 When an entity distributes the assets to its owners, it derecognises both the assets distributed and the dividend payable.
- BC39 The IFRIC noted that, at the time of settlement, the carrying amount of the assets distributed would not normally be greater than the carrying amount of the dividend payable because of the recognition of impairment losses required by other applicable standards. For example, paragraph 59 of IAS 36 *Impairment of Assets* requires an entity to recognise an impairment loss in profit or loss when the recoverable amount of an asset is less than its carrying amount. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use in accordance with paragraph 6 of IAS 36. When an entity has an obligation to distribute the asset to its owners in the near future, it would not seem appropriate to measure an impairment loss using the asset's value in use. Furthermore, IFRS 5 requires an entity to measure an asset held for sale at the lower of its carrying amount and its fair value less costs to sell. Consequently, the IFRIC concluded that when an entity derecognises the dividend payable and the asset distributed, any difference will always be a credit balance (referred to below as the credit balance).

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 does not address dividends. Dividends should be accounted for in accordance with IFRS 9, or IAS 39 if applicable.

IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC40 In determining how the credit balance should be accounted for, the IFRIC first considered whether it should be recognised as an owner change in equity.
- BC41 The IFRIC acknowledged that an asset distribution was a transaction between an entity and its owners. The IFRIC also observed that distributions to owners are recognised as owner changes in equity in accordance with IAS 1 (as revised in 2007). However, the IFRIC noted that the credit balance did not arise from the distribution transaction. Rather, it represented the cumulative unrecognised gain associated with the asset. It reflects the performance of the entity during the period the asset was held until it was distributed.
- BC42 Some might argue that, since an asset distribution does not result in the owners of an entity losing the future economic benefits of the asset, the credit balance should be recognised directly in equity. This view would be based upon the proprietary perspective in which the reporting entity does not have substance of its own separate from that of its owners. However, the IFRIC noted that the *Framework* requires an entity to consider the effect of a transaction from the perspective of the entity for which the financial statements are prepared. Under the entity perspective, the reporting entity has substance of its own, separate from that of its owners. In addition, when there is more than one class of equity instruments, the argument that all owners of an entity have effectively the same interest in the asset would not be valid.
- BC43 For the reasons described in paragraphs BC41 and BC42, the IFRIC concluded that the credit balance should not be recognised as an owner change in equity.
- BC44 The IFRIC noted that, as explained in the Basis for Conclusions on IAS 1, the Board explicitly prohibited any income or expenses (ie non-owner changes in equity) from being recognised directly in the statement of changes in equity. Any such income or expenses must be recognised as items of comprehensive income first.
- BC45 The statement of comprehensive income in accordance with IAS 1 includes two components: items of profit or loss, and items of other comprehensive income. The IFRIC therefore discussed whether the credit balance should be recognised in profit or loss or in other comprehensive income.
- BC46 IAS 1 does not provide criteria for when an item should be recognised in profit or loss. However, paragraph 88 of IAS 1 states: 'An entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.'
- BC47 The IFRIC considered the circumstances in which IFRSs require items of income and expense to be recognised as items of other comprehensive income, mainly as follows:
- (a) some actuarial gains or losses arising from remeasuring defined benefit liabilities provided that specific criteria set out in IAS 19 are met.
 - (b) a revaluation surplus arising from revaluation of an item of property, plant and equipment in accordance with IAS 16 or revaluation of an intangible asset in accordance with IAS 38.
 - (c) an exchange difference arising from the translation of the results and financial positions of an entity from its functional currency into a presentation currency in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.
 - (d) an exchange difference arising from the translation of the results and financial position of a foreign operation into a presentation currency of a reporting entity for consolidation purposes in accordance with IAS 21.
 - (e) a change in the fair value of an available-for-sale investment* in accordance with IAS 39.
 - (f) a change in the fair value of a hedging instrument qualifying for cash flow hedge accounting in accordance with IAS 39.[#]

* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.

IFRS 9 *Financial Instruments* replaced the hedge accounting requirements in IAS 39.

- BC48 The IFRIC concluded that the requirement in IAS 1 prevents any of these items from being applied by analogy to the credit balance. In addition, the IFRIC noted that, with the exception of the items described in paragraph BC47(a)–(c), the applicable IFRSs require the items of income and expenses listed in paragraph BC47 to be reclassified to profit or loss when the related assets or liabilities are derecognised. Those items of income and expenses are recognised as items of other comprehensive income when incurred, deferred in equity until the related assets are disposed of (or the related liabilities are settled), and reclassified to profit or loss at that time.
- BC49 The IFRIC noted that, when the dividend payable is settled, the asset distributed is also derecognised. Therefore, given the existing requirements in IFRSs, even if the credit balance were recognised as an item of other comprehensive income, it would have to be reclassified to profit or loss immediately. As a result, the credit balance would appear three times in the statement of comprehensive income—once recognised as an item of other comprehensive income, once reclassified out of other comprehensive income to profit or loss and once recognised as an item of profit or loss as a result of the reclassification. The IFRIC concluded that such a presentation does not faithfully reflect what has occurred. In addition, users of financial statements were likely to be confused by such a presentation.
- BC50 Moreover, when an entity distributes its assets to its owners, it loses the future economic benefit associated with the assets distributed and derecognises those assets. Such a consequence is, in general, similar to that of a disposal of an asset. IFRSs (eg IAS 16, IAS 38, IAS 39[#] and IFRS 5) require an entity to recognise in profit or loss any gain or loss arising from the derecognition of an asset. IFRSs also require such a gain or loss to be recognised when the asset is derecognised. As mentioned in paragraph BC42, the *Framework* requires an entity to consider the effect of a transaction from the perspective of an entity for which the financial statements are prepared. For these reasons, the IFRIC concluded that the credit balance and gains or losses on derecognition of an asset should be accounted for in the same way.
- BC51 Furthermore, paragraph 92 of the *Framework*^{*} states: ‘Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably’ (emphasis added). At the time of the settlement of a dividend payable, there is clearly a decrease in a liability. Therefore, the credit balance should be recognised in profit or loss in accordance with paragraph 92 of the *Framework*. Some might argue that the entity does not receive any additional economic benefits when it distributes the assets to its owners. As mentioned in paragraph BC41, the credit balance does not represent any additional economic benefits to the entity. Instead, it represents the unrecognised economic benefits that the entity obtained while it held the assets.
- BC52 The IFRIC also noted that paragraph 55 of the *Framework*[†] states: ‘The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be: (a) used singly or in combination with other assets in the production of goods or services to be sold by the entity; (b) exchanged for other assets; (c) used to settle a liability; or (d) distributed to the owners of the entity [emphasis added].’
- BC53 In the light of these requirements, in D23 the IFRIC concluded that the credit balance should be recognised in profit or loss. This treatment would give rise to the same accounting results regardless of whether an entity distributes non-cash assets to its owners, or sells the non-cash assets first and distributes the cash received to its owners. Most commentators on D23 supported the IFRIC’s conclusion and its basis.
- BC54 Some IFRIC members believed that it would be more appropriate to treat the distribution as a single transaction with owners and therefore recognise the credit balance directly in equity. This alternative view was included in D23 and comments were specifically invited. However, this view was not supported by commentators. To be recognised directly in equity, the credit balance must be considered an owner change in equity in accordance with IAS 1. The IFRIC decided that the credit balance does not arise from the distribution transaction. Rather, it represents the increase in value of the assets. The increase in the value of the asset does not meet the definition of an owner change in equity in accordance with IAS 1. Rather, it meets the definition of income and should be recognised in profit and loss.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} now paragraph 4.47 of the *Conceptual Framework*

[†] now paragraph 4.10 of the *Conceptual Framework*

Effective for transfers of assets from
customers received on or after 1 July 2009

HK(IFRIC) Interpretation 18

Transfers of Assets from Customers

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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HK(IFRIC)-Int 19
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Effective for annual periods
beginning on or after 1 July 2010

HK(IFRIC) Interpretation 19

Extinguishing Financial Liabilities with Equity Instruments



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Appendix

Amendment to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*

Basis for Conclusions

Hong Kong (IFRIC) Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments* (HK(IFRIC)-Int 19) is set out in paragraphs 1–17~~5~~ and the Appendix. HK(IFRIC)-Int 19 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 19

Extinguishing Financial Liabilities with Equity Instruments

References

- *Framework for the Preparation and Presentation of Financial Statements*^{*}
- HKFRS 2 *Share-based Payment*
- HKFRS 3 (Revised) *Business Combinations*
- HKFRS 9 *Financial Instruments*
- HKFRS 13 *Fair Value Measurement*
- HKAS 1 *Presentation of Financial Statements*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 32 *Financial Instruments: Presentation*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~

Background

- 1 A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'. The International Financial Reporting Interpretations Committee has received requests for guidance on the accounting for such transactions.

Scope

- 2 This Interpretation addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.
- 3 An entity shall not apply this Interpretation to transactions in situations where:
 - (a) the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder.
 - (b) the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.
 - (c) extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.

* In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

Issues

- 4 This Interpretation addresses the following issues:
- (a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph ~~41 of HKAS 393.3.3 of~~ HKFRS 9?
 - (b) How should an entity initially measure the equity instruments issued to extinguish such a financial liability?
 - (c) How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

Conclusions

- 5 The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph ~~41 of HKAS 393.3.3 of~~ HKFRS 9. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph ~~39 of HKAS 393.3.1 of~~ HKFRS 9.
- 6 When equity instruments issued to a creditor to extinguish all or part of a financial liability are recognised initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.
- 7 If the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished. In measuring the fair value of a financial liability extinguished that includes a demand feature (eg a demand deposit), paragraph 47 of HKFRS 13 is not applied.
- 8 If only part of the financial liability is extinguished, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid does relate to a modification of the terms of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity shall consider all relevant facts and circumstances relating to the transaction in making this allocation.
- 9 The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in profit or loss, in accordance with paragraph ~~41 of HKAS 393.3.3 of~~ HKFRS 9. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.
- 10 When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph 8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph ~~40 of HKAS 393.3.2 of~~ HKFRS 9.
- 11 An entity shall disclose a gain or loss recognised in accordance with paragraphs 9 and 10 as a separate line item in profit or loss or in the notes.

Effective date and transition

- 12 An entity shall apply this Interpretation for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 July 2010, it shall disclose that fact.
- 13 An entity shall apply a change in accounting policy in accordance with HKAS 8 from the beginning of the earliest comparative period presented.
- 14 ~~[This paragraph refers to amendments with an effective date after 1 January 2013, and is therefore not included in this edition.]~~[Deleted]
- 15 HKFRS 13, issued in June 2011, amended paragraph 7. An entity shall apply that amendment when it applies HKFRS 13.
- 16 [Deleted]
- 17 HKFRS 9, as issued in September 2014, amended paragraphs 4, 5, 9 and 10 and deleted paragraphs 14 and 16. An entity shall apply those amendments when it applies HKFRS 9.

Appendix
Amendment to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*

The amendment in this appendix shall be applied for annual periods beginning on or after 1 July 2010. If an entity applies this Interpretation for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standard.

Basis for Conclusions on HK(IFRIC)-Int 19

This Basis for Conclusions accompanies, but is not part of, IFRIC 19.

HK(IFRIC)-Int 19 is based on IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*. In approving HK(IFRIC)-Int 19, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 19. Accordingly, there are no significant differences between HK(IFRIC)-Int 19 and IFRIC Interpretation 19. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 19 referred to below generally correspond with those in HK(IFRIC)-Int 19.

Introduction

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.
- BC2 The IFRIC received a request for guidance on the application of IAS 39 *Financial Instruments: Recognition and Measurement** and IAS 32 *Financial Instruments: Presentation* when an entity issues its own equity instruments to extinguish all or part of a financial liability. The question is how the entity should recognise the equity instruments issued.
- BC3 The IFRIC noted that lenders manage loans to entities in financial difficulty in a variety of ways including one or more of the following:
- (a) selling the loans in the market to other investors/lenders;
 - (b) renegotiating the terms of the loan (eg extension of the maturity date or lower interest payments); or
 - (c) accepting the creditor's equity instruments in full or partial settlement of the liability (sometimes referred to as a 'debt for equity swap').
- BC4 The IFRIC was informed that there was diversity in practice in how entities measure the equity instruments issued in full or partial settlement of a financial liability following renegotiation of the terms of the liability. Some recognise the equity instruments at the carrying amount of the financial liability and do not recognise any gain or loss in profit or loss. Others recognise the equity instruments at the fair value of either the liability extinguished or the equity instruments issued and recognise a difference between that amount and the carrying amount of the financial liability in profit or loss.
- BC5 In August 2009 the IFRIC published draft Interpretation D25 *Extinguishing Financial Liabilities with Equity Instruments* for public comment. It received 33 comment letters in response to the proposals.

Scope

- BC6 The IFRIC concluded that its Interpretation should address only the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish part or all of the liability. It does not address the accounting by the creditor because other IFRSs already set out the relevant requirements.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC7 The IFRIC considered whether to provide guidance on transactions in which the creditor is also a direct or indirect shareholder and is acting in its capacity as an existing direct or indirect shareholder. The IFRIC concluded that the Interpretation should not address such transactions. It noted that determining whether the issue of equity instruments to extinguish a financial liability in such situations is considered a transaction with an owner in its capacity as an owner would be a matter of judgement depending on the facts and circumstances.
- BC8 In its redeliberations, the IFRIC clarified that transactions when the creditor and the entity are controlled by the same party or parties before and after the transaction are outside the scope of the Interpretation when the substance of the transaction includes an equity distribution by, or contribution to, the entity. The IFRIC acknowledged that the allocation of consideration between the extinguishment of all or part of a financial liability and the equity distribution or contribution components may not always be reliably measured.
- BC9 Some respondents questioned whether the Interpretation should be applied to transactions when the extinguishment of the financial liability by issuing equity shares is in accordance with the original terms of the liability. In its redeliberations the IFRIC decided that these transactions should be excluded from the scope of the Interpretation, noting that IAS 32 includes specific guidance on those financial instruments.

Are an entity's equity instruments 'consideration paid'?

- BC10 The IFRIC noted that IFRSs do not contain specific guidance on the measurement of an entity's equity instruments issued to extinguish all or part of a financial liability. Paragraph 41 of IAS 39^{*} requires an entity to recognise in profit or loss the difference between the carrying amount of the financial liability extinguished and the consideration paid. That paragraph describes 'consideration paid' as including non-cash assets transferred, or liabilities assumed, and does not specifically mention equity instruments issued. Consequently, some are of the view that equity instruments are not 'consideration paid'.
- BC11 Holders of this view believe that, because IFRSs are generally silent on how to measure equity instruments on initial recognition (see paragraph BC15), a variety of practices has developed. One such practice is to recognise the equity instruments issued at the carrying amount of the financial liability extinguished.
- BC12 However, the IFRIC observed that both IFRS 2 *Share-based Payment* and IFRS 3 *Business Combinations* make it clear that equity instruments are used as consideration to acquire goods and services as well as to obtain control of businesses.
- BC13 The IFRIC also observed that the issue of equity instruments to extinguish a financial liability could be analysed as consisting of two transactions—first, the issue of new equity instruments to the creditor for cash and second, the creditor accepting payment of that amount of cash to extinguish the financial liability.
- BC14 As a result of its analysis, the IFRIC concluded that the equity instruments issued to extinguish a financial liability are 'consideration paid' in accordance with paragraph 41 of IAS 39.

How should the equity instruments be measured?

- BC15 The IFRIC observed that although IFRSs do not contain a general principle for the initial recognition and measurement of equity instruments, guidance on specific transactions exists, including:
- (a) *initial recognition of compound instruments* (IAS 32). The amount allocated to the equity component is the residual after deducting the fair value of the financial liability component from the fair value of the entire compound instrument.

* IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- (b) *cost of equity transactions and own equity instruments ('treasury shares') acquired and reissued or cancelled* (IAS 32). No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. These are transactions with an entity's owners in their capacity as owners.
 - (c) *equity instruments issued in share-based payment transactions* (IFRS 2). For equity-settled share-based payment transactions, the entity measures the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received (eg transactions with employees), the entity measures their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.
 - (d) *consideration transferred in business combinations* (IFRS 3). The total consideration transferred in a business combination is measured at fair value. It includes the acquisition-date fair values of any equity interests issued by the acquirer.
- BC16 The IFRIC noted that the general principle of IFRSs is that equity is a residual and should be measured initially by reference to changes in assets and liabilities (the *Framework*^{*} and IFRS 2). IFRS 2 is clear that when goods or services are received in return for the issue of equity instruments, the increase in equity is measured directly at the fair value of the goods or services received.
- BC17 The IFRIC decided that the same principles should apply when equity instruments are issued to extinguish financial liabilities. However, the IFRIC was concerned that entities might encounter practical difficulties in measuring the fair value of both the equity instruments issued and the financial liability, particularly when the entity is in financial difficulty. Therefore, the IFRIC decided in D25 that equity instruments issued to extinguish a financial liability should be measured initially at the fair value of the equity instruments issued or the fair value of the liability extinguished, whichever is more reliably determinable.
- BC18 However, in response to comments received on D25, the IFRIC reconsidered whether the entity should initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the equity instruments issued or the fair value of the liability extinguished. The IFRIC noted that many respondents proposed that a preferred measurement basis should be determined to avoid an 'accounting choice' developing in practice, acknowledging that both measurement approaches would need to be used to identify which was more reliably determinable.
- BC19 Therefore the IFRIC decided to modify the proposal in D25 and identify a preferred measurement basis. In identifying this preferred measurement basis, the IFRIC noted that many respondents considered that the principles in IFRS 2 and the *Framework* referred to in paragraph BC16 support a measurement based on the fair value of the liability extinguished.
- BC20 However, some respondents argued that the fair value of the equity issued should be the proposed measurement basis. They pointed out that this approach would be consistent with the consensus that the issue of an entity's equity instruments is consideration paid in accordance with paragraph 41 of IAS 39.[#] They also argued that the fair value of the equity issued best reflects the total amount of consideration paid in the transaction, which may include a premium that the creditor requires to renegotiate the terms of the financial liability.

* References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC21 The IFRIC considered that the fair value of the equity issued should be the proposed measurement basis for the reasons described in paragraph BC20. Consequently the IFRIC concluded that an entity should initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured. If the fair value of the equity instruments issued cannot be reliably measured then these equity instruments should initially be measured to reflect the fair value of the liability extinguished.
- BC22 In redeliberations, the IFRIC noted that these transactions often take place in situations when the terms of the financial liability are breached and the liability becomes repayable on demand. The IFRIC agreed with comments received that paragraph 49 of IAS 39 is not applied in measuring the fair value of all or part of a financial liability extinguished in these situations.¹ This is because the extinguishment transaction suggests that the demand feature is no longer substantive.
- BC23 In response to comments, the IFRIC also clarified that the equity instruments issued should be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished. This is consistent with paragraphs BC341 and BC342 of the Basis for Conclusions on IFRS 3, which discuss the views on whether equity instruments issued as consideration in a business combination should be measured at fair value at the agreement date or acquisition date, concluding that measurement should be at the acquisition date.

How should a difference between the carrying amount of the financial liability and the consideration paid be accounted for?

- BC24 In accordance with paragraph 41 of IAS 39,[§] the entity should recognise a gain or loss in profit or loss for any difference between the carrying amount of the financial liability extinguished and the consideration paid. This requirement is consistent with the *Framework's* discussion of income:
- (a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or *decreases of liabilities that result in increases in equity*, other than those relating to contributions from equity participants. (paragraph 70(a))* (emphasis added)
 - (b) Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits ... (paragraph 75)[†]
 - (c) Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan. (paragraph 77)[#]

Full extinguishment

- BC25 The IFRIC noted that, as discussed in paragraph BC13, a transaction in which an entity issues equity instruments to extinguish a liability can be analysed as first, the issue of new equity instruments to the creditor for cash and second, the creditor accepting payment of that amount of cash to extinguish the financial liability. Consistently with paragraph BC24, when

¹ IFRS 9 *Financial Instruments* replaced IAS 39. Paragraph 49 of IAS 39 was ultimately relocated to paragraph 47 of IFRS 13 *Fair Value Measurement*. Paragraph BC22 refers to matters relevant when IFRIC 19 was issued.

[§] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} now paragraph 4.25(a) of the *Conceptual Framework*

[†] now paragraph 4.30 of the *Conceptual Framework*

[#] now paragraph 4.32 of the *Conceptual Framework*

the creditor accepts cash to extinguish the liability, the entity should recognise a gain or loss in profit or loss.

- BC26 Similarly, the IFRIC noted that, in accordance with IAS 32, when an entity amends the terms of a convertible instrument to induce early conversion, the entity recognises in profit or loss the fair value of any additional consideration paid to the holder. Thus, the IFRIC concluded that when an entity settles an instrument by issuing its own equity instruments and that settlement is not in accordance with the original terms of the financial liability, the entity should recognise a gain or loss in profit or loss.
- BC27 As a result of its conclusions, the IFRIC decided that the entity should recognise a gain or loss in profit or loss. This gain or loss is equal to the difference between the carrying amount of the financial liability and the fair value of the equity instruments issued, or fair value of the liability extinguished if the fair value of the equity instruments issued cannot be reliably measured.

Partial extinguishment

- BC28 The IFRIC also observed that the restructuring of a financial liability can involve both the partial settlement of the liability by the issue of equity instruments to the creditor and the modification of the terms of the liability that remains outstanding. Therefore, the IFRIC decided that the Interpretation should also apply to partial extinguishments. In the case of a partial extinguishment, the discussion in paragraphs BC25–BC27 applies to the part of the liability extinguished.
- BC29 Many respondents requested clarification of the guidance on partial extinguishment included in D25. During its redeliberations, the IFRIC acknowledged that the issue of an entity's equity shares may reflect consideration paid for both the extinguishment of part of a financial liability and the modification of the terms of the part of the liability that remains outstanding.
- BC30 The IFRIC decided that to reflect this, an entity should allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity would consider this allocation in determining the profit or loss to be recognised on the part of the liability extinguished and in its assessment of whether the terms of the remaining liability have been substantially modified.
- BC31 The IFRIC concluded that providing additional guidance on determining whether the terms of the part of the financial liability that remains outstanding has been substantially modified in accordance with paragraph 40 of IAS 39[#] was outside the scope of the Interpretation.

Presentation

- BC32 The IFRIC decided that an entity should disclose the gain or loss on the extinguishment of the financial liability by the issue of equity instruments as a separate line item in profit or loss or in the notes. This requirement is consistent with the *Framework* and the requirements in other IFRSs, for example:
- (a) When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. (paragraph 76 of the *Framework*)*
 - (b) An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

* now paragraph 4.31 of the *Conceptual Framework*

such presentation is relevant to an understanding of the entity's financial performance. (paragraph 85 of IAS 1 *Presentation of Financial Statements*)

- (c) An entity shall disclose net gains or net losses on financial liabilities either in the statement of comprehensive income or in the notes. (paragraph 20 of IFRS 7 *Financial Instruments: Disclosures*)

Transition

- BC33 The IFRIC decided that the Interpretation should be applied retrospectively even though it acknowledged that determining fair values retrospectively may be problematic. The IFRIC noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides guidance on circumstances in which retrospective application might be impracticable. The IFRIC concluded that it was preferable to require entities that could apply the Interpretation retrospectively to do so, rather than requiring all entities to apply it prospectively to future transactions. However, to simplify transition, the IFRIC also concluded that it should require retrospective application only from the beginning of the earliest comparative period presented because application to earlier periods would result only in a reclassification of amounts within equity.

Summary of main changes from the draft Interpretation

- BC34 The main changes from the IFRIC's proposals in D25 are as follows:
- (a) Paragraph 3 was added because the IFRIC identified specific transactions that are outside of the scope of the Interpretation.
 - (b) Paragraph 6 was modified to state that measurement should be based on the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.
 - (c) Paragraph 7 was added to reflect the modification to paragraph 6. It also clarifies the intention of the IFRIC that in measuring the fair value of a financial liability extinguished that includes a demand feature (eg a demand deposit), paragraph 49 of IAS 39* is not applied.
 - (d) Paragraph 8 was added, and paragraph 10 was modified, to clarify how the Interpretation should be applied when only part of the financial liability is extinguished by the issue of equity instruments.
 - (e) Paragraph 9 was modified to state when the equity instruments issued should be initially measured.

* IFRS 9 *Financial Instruments* replaced IAS 39. Paragraph 49 of IAS 39 was ultimately relocated to paragraph 47 of IFRS 13 *Fair Value Measurement*. Paragraph BC22 refers to matters relevant when IFRIC 19 was issued.

Effective for annual reporting periods
beginning on or after 1 January 2018

HK(IFRIC) Interpretation 22

Foreign Currency Transactions and Advance Consideration



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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*from ~~page~~ paragraph***HONG KONG (IFRIC) INTERPRETATION 22 FOREIGN CURRENCY
TRANSACTIONS AND ADVANCE CONSIDERATION**

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Hong Kong (IFRIC) Interpretation 22 *Foreign Currency Transactions and Advance Consideration* (HK(IFRIC)-Int 22) is set out in paragraphs 1–9 and Appendices A and B. HK(IFRIC)-Int 22 is accompanied by Illustrative Examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Scope

- 4 This Interpretation applies to a foreign currency transaction (or part of it) when an entity recognises a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration before the entity recognises the related asset, expense or income (or part of it).
- 5 This Interpretation does not apply when an entity measures the related asset, expense or income on initial recognition:
 - (a) at fair value; or
 - (b) at the fair value of the consideration paid or received at a date other than the date of initial recognition of the non-monetary asset or non-monetary liability arising from advance consideration (for example, the measurement of goodwill applying HKFRS 3 *Business Combinations*).
- 6 An entity is not required to apply this Interpretation to:
 - (a) income taxes; or
 - (b) insurance contracts (including reinsurance contracts) that it issues or reinsurance contracts that it holds.

Issue

- 7 This Interpretation addresses how to determine the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration in a foreign currency.

Conclusions

- 8 Applying paragraphs 21–22 of HKAS 21, the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) is the date on which an entity initially recognises the non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration.
- 9 If there are multiple payments or receipts in advance, the entity shall determine a date of the transaction for each payment or receipt of advance consideration.

Appendix B

The amendment in this Appendix shall be applied for annual reporting periods beginning on or after 1 January 2018. If an entity applies this Interpretation for an earlier period this amendment shall be applied for that earlier period.

Amendment to HKFRS 1 First-time Adoption of Hong Kong Financial Reporting Standards

The amendment contained in this appendix when this Interpretation was issued in 2017 has been incorporated into the text of HKFRS 1.

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong (SIC) Interpretation 27

Evaluating the Substance of Transactions Involving the Legal Form of a Lease



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Interpretation 27

Evaluating the Substance of Transactions Involving the Legal Form of a Lease

HK(SIC) Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (HK(SIC)-Int 27) is set out in paragraphs 3-11. HK(SIC)-Int 27 is accompanied by a Basis for Conclusions and appendices illustrating the application of the Interpretation. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- ~~HKAS 11 *Construction Contracts*~~
- HKAS 17 *Leases*
- ~~HKAS 18 *Revenue*~~
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003)~~
- HKFRS 4 *Insurance Contracts*
- HKFRS 9 *Financial Instruments*
- HKFRS 15 *Revenue from Contracts with Customers*

Issue

- 1 An Entity may enter into a transaction or a series of structured transactions (an arrangement) with an unrelated party or parties (an Investor) that involves the legal form of a lease. For example, an Entity may lease assets to an Investor and lease the same assets back, or alternatively, legally sell assets and lease the same assets back. The form of each arrangement and its terms and conditions can vary significantly. In the lease and leaseback example, it may be that the arrangement is designed to achieve a tax advantage for the Investor that is shared with the Entity in the form of a fee, and not to convey the right to use an asset.
- 2 When an arrangement with an Investor involves the legal form of a lease, the issues are:
 - (a) how to determine whether a series of transactions is linked and should be accounted for as one transaction;
 - (b) whether the arrangement meets the definition of a lease under HKAS 17; and, if not,
 - (i) whether a separate investment account and lease payment obligations that might exist represent assets and liabilities of the Entity (eg, consider the example described in paragraph A2(a) of Appendix A);
 - (ii) how the Entity should account for other obligations resulting from the arrangement; and
 - (iii) how the Entity should account for a fee it might receive from an Investor.

Conclusions

- 3 A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence. (Appendix A provides illustrations of application of this Interpretation.)

- 4 The accounting shall reflect the substance of the arrangement. All aspects and implications of an arrangement shall be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.
- 5 HKAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under HKAS 17 include (Appendix B provides illustrations of application of this Interpretation):
- (a) an Entity retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement;
 - (b) the primary reason for the arrangement is to achieve a particular tax result, and not to convey the right to use an asset; and
 - (c) an option is included on terms that make its exercise almost certain (eg, a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).
- 6 The definitions and guidance in paragraphs 49 – 64 of the *Framework*^{*} shall be applied in determining whether, in substance, a separate investment account and lease payment obligations represent assets and liabilities of the Entity. Indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and shall not be recognised by the Entity include:
- (a) the Entity is not able to control the investment account in pursuit of its own objectives and is not obligated to pay the lease payments. This occurs when, for example, a prepaid amount is placed in a separate investment account to protect the Investor and may only be used to pay the Investor, the Investor agrees that the lease payment obligations are to be paid from funds in the investment account, and the Entity has no ability to withhold payments to the Investor from the investment account;
 - (b) the Entity has only a remote risk of reimbursing the entire amount of any fee received from an Investor and possibly paying some additional amount, or, when a fee has not been received, only a remote risk of paying an amount under other obligations (eg, a guarantee). Only a remote risk of payment exists when, for example, the terms of the arrangement require that a prepaid amount is invested in risk-free assets that are expected to generate sufficient cash flows to satisfy the lease payment obligations; and
 - (c) other than the initial cash flows at inception of the arrangement, the only cash flows expected under the arrangement are the lease payments that are satisfied solely from funds withdrawn from the separate investment account established with the initial cash flows.
- 7 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under HKAS 37, ~~HKAS 39 or~~ HKFRS 4 or HKFRS 9, depending on the terms.
- 8 The ~~criteria requirements in paragraph 20 of HKAS 18~~ HKFRS 15 shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Entity might receive. Factors such as whether there is continuing involvement in the form of significant future performance obligations necessary to earn the fee, whether there are retained risks, the terms of any guarantee arrangements, and the risk of repayment of the fee, shall be considered. Indicators that individually demonstrate that recognition of the entire fee as income when received, if received at the beginning of the arrangement, is inappropriate include:
- (a) obligations either to perform or to refrain from certain significant activities are conditions of earning the fee received, and therefore execution of a legally binding arrangement is not the most significant act required by the arrangement;
 - (b) limitations are put on the use of the underlying asset that have the practical effect of restricting and significantly changing the Entity's ability to use (eg, deplete, sell or pledge as collateral) the asset;

* The reference to *Framework* is to *Framework for the Preparation and Presentation of Financial Statements*, issued by the HKICPA in 1997. In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 49-64 are now paragraphs 4.4-4.19 of the *Conceptual Framework*.

- (c) the possibility of reimbursing any amount of the fee and possibly paying some additional amount is not remote. This occurs when, for example,
- (i) the underlying asset is not a specialised asset that is required by the Entity to conduct its business, and therefore there is a possibility that the Entity may pay an amount to terminate the arrangement early; or
 - (ii) the Entity is required by the terms of the arrangement, or has some or total discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (eg, currency, interest rate or credit risk). In this circumstance, the risk of the investment's value being insufficient to satisfy the lease payment obligations is not remote, and therefore there is a possibility that the Entity may be required to pay some amount.
- 9 The fee shall be presented in the statement of comprehensive income based on its economic substance and nature.

Disclosure

- 10 All aspects of an arrangement that does not, in substance, involve a lease under HKAS 17 shall be considered in determining the appropriate disclosures that are necessary to understand the arrangement and the accounting treatment adopted. An Entity shall disclose the following in each period that an arrangement exists:
- (a) a description of the arrangement including:
 - (i) the underlying asset and any restrictions on its use;
 - (ii) the life and other significant terms of the arrangement;
 - (iii) the transactions that are linked together, including any options; and
 - (b) the accounting treatment applied to any fee received, the amount recognised as income in the period, and the line item of the statement of comprehensive income in which it is included.
- 11 The disclosures required in accordance with paragraph 10 of this Interpretation shall be provided individually for each arrangement or in aggregate for each class of arrangement. A class is a grouping of arrangements with underlying assets of a similar nature (eg, power plants).

Basis for Conclusions

HK(SIC)-Int 27 is based on SIC Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. In approving HK(SIC)-Int 27, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the SIC's Basis for Conclusions on SIC Interpretation 27. Accordingly, there are no significant differences between HK(SIC)-Int 27 and SIC Interpretation 27. The SIC's Basis for Conclusions is reproduced below. The paragraph numbers of SIC Interpretation 27 referred to below generally correspond with those in HK(SIC)-Int 27.

This Basis for Conclusions accompanies, but is not part of, SIC-27.

[The requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments. To avoid confusion with earlier amendments marked up on the original text to reflect the revision of IAS 39 in 2003 and the subsequent issue of IFRS 4, paragraphs 14 and 15 have been amended for consistency with IFRS 9. References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.]

- 12 Paragraph 9 of IAS 11 *Construction Contracts*,* requires a group of contracts to be treated as a single contract when the group of contracts is negotiated as a single package, the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin, and the contracts are performed concurrently or in a continuous sequence. In such a situation, a series of transactions that involve the legal form of a lease are linked and accounted for as one transaction, because the overall economic effect cannot be understood without reference to the series of transactions as a whole.

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts*. IFRS 15 requires contracts to be combined if they meet specified criteria.

- 13 An agreement is accounted for as a lease in accordance with IAS 17 when it conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. For information to represent faithfully the transactions it purports to represent, paragraph 35 of the *Framework*^β indicates that it is necessary that transactions are accounted for and presented in accordance with their substance and economic reality, not merely their legal form.
- 14 When an Entity does not control the assets that will be used to satisfy the lease payment obligations, and is not obligated to pay the lease payments, it does not recognise the assets and lease payment obligations, because the definitions of an asset and a liability have not been met. This is different from the circumstance when an Entity controls the assets, is obligated to pay the lease payments, and then later transfers assets to a third party (including a trust). In that circumstance, the transfer of assets (sometimes called an 'in-substance' defeasance) does not by itself relieve the Entity of its primary obligation, in the absence of legal release. A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs ~~15-37, 39-42, AG36-AG52 and AG57-AG63 of IAS 39~~3.2.1-3.2.23, 3.3.1-3.3.4, B3.2.1-B3.2.17 and B3.3.1-B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an 'underlying') are subject to IAS 39.[#]
- 16 IAS 18* addresses the accounting treatment of revenue. Paragraph 75 of the *Framework*^δ indicates that gains are no different in nature from revenue. Therefore, the requirements of IAS 18 apply by analogy or otherwise. Example 14(c) in the Appendix of IAS 18 states that a fee earned on the execution of a significant act, which is much more significant than any other act, is recognised as income when the significant act has been completed. The example also indicates that it is necessary to distinguish between fees earned on completion of a significant act and fees related to future performance or risks retained.

Date of issue

December 2004

Effective date

This Interpretation becomes effective for annual accounting periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies shall be accounted for in accordance with HKAS 8.

This Interpretation supersedes Interpretation 14 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (issued in July 2002).

HKFRS 9 amended paragraph 7. An entity shall apply that amendment when it applies HKFRS 9.

HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended the 'References' section and paragraph 8. An entity shall apply those amendments when it applies HKFRS 15.

^β superseded by Chapter 3 of the *Conceptual Framework*. References to the *Framework* are to IASB's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 eliminated the guidance on recognising revenue on the execution of a significant act.

^δ now paragraph 4.30 of the *Conceptual Framework*.

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong (SIC) Interpretation 31

Revenue — Barter Transactions Involving Advertising Services

This Standard is superseded by HKFRS 15 *Revenue from Contracts with Customers*. HKFRS 15 shall be applied for annual reporting period on or after 1 January 2018.



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Effective for annual periods
beginning on or after 1 January 2005

Hong Kong (SIC) Interpretation 32

Intangible Assets — Web Site Costs



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Hong Kong (SIC) Interpretation 32

Intangible Assets - Web Site Costs

HK(SIC) Interpretation 32 *Intangible Assets - Web Site Costs* (HK(SIC)-Int 32) is set out in paragraphs 7-10. HK(SIC)-Int 32 is accompanied by a Basis for Conclusions and appendix illustrating the application of the Interpretation. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKFRS 3 *Business Combinations*
- HKFRS 15 *Revenue from Contracts with Customers*
- HKAS 1 *Presentation of Financial Statements* (as revised in 2007)
- HKAS 2 *Inventories*
- ~~HKAS 11 *Construction Contracts*~~
- HKAS 16 *Property, Plant and Equipment*
- HKAS 17 *Lease*
- HKAS 36 *Impairment of Assets*
- HKAS 38 *Intangible Assets*

Issue

- 1 An entity may incur internal expenditure on the development and operation of its own web site for internal or external access. A web site designed for external access may be used for various purposes such as to promote and advertise an entity's own products and services, provide electronic services, and sell products and services. A web site designed for internal access may be used to store company policies and customer details, and search relevant information.
- 2 The stages of a web site's development can be described as follows:
 - (a) Planning - includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences.
 - (b) Application and Infrastructure Development - includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing.
 - (c) Graphical Design Development - includes designing the appearance of web pages.
 - (d) Content Development - includes creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site before the completion of the web site's development. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.
- 3 Once development of a web site has been completed, the Operating stage begins. During this stage, an entity maintains and enhances the applications, infrastructure, graphical design and content of the web site.

- 4 When accounting for internal expenditure on the development and operation of an entity's own web site for internal or external access, the issues are:
- (a) whether the web site is an internally generated intangible asset that is subject to the requirements of HKAS 38; and
 - (b) the appropriate accounting treatment of such expenditure.
- 5 This Interpretation does not apply to expenditure on purchasing, developing, and operating hardware (eg web servers, staging servers, production servers and Internet connections) of a web site. Such expenditure is accounted for under HKAS 16 ~~Property, Plant and Equipment~~. Additionally, when an entity incurs expenditure on an Internet service provider hosting the entity's web site, the expenditure is recognised as an expense under HKAS 1.88 and the *Framework*¹ when the services are received.
- 6 HKAS 38 does not apply to intangible assets held by an entity for sale in the ordinary course of business (see HKAS 2 and ~~HKAS 11~~HKFRS 15) or leases that fall within the scope of HKAS 17. Accordingly, this Interpretation does not apply to expenditure on the development or operation of a web site (or web site software) for sale to another entity. When a web site is leased under an operating lease, the lessor applies this Interpretation. When a web site is leased under a finance lease, the lessee applies this Interpretation after initial recognition of the leased asset.

Conclusions

- 7 An entity's own web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of HKAS 38.
- 8 A web site arising from development shall be recognised as an intangible asset if, and only if, in addition to complying with the general requirements described in HKAS 38.21 for recognition and initial measurement, an entity can satisfy the requirements in HKAS 38.57. In particular, an entity may be able to satisfy the requirement to demonstrate how its web site will generate probable future economic benefits in accordance with HKAS 38.57(d) when, for example, the web site is capable of generating revenues, including direct revenues from enabling orders to be placed. An entity is not able to demonstrate how a web site developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, and consequently all expenditure on developing such a web site shall be recognised as an expense when incurred.
- 9 Any internal expenditure on the development and operation of an entity's own web site shall be accounted for in accordance with HKAS 38. The nature of each activity for which expenditure is incurred (eg training employees and maintaining the web site) and the web site's stage of development or post-development shall be evaluated to determine the appropriate accounting treatment (additional guidance is provided in the Appendix to this Interpretation). For example:
- (a) the Planning stage is similar in nature to the research phase in HKAS 38.54-.56. Expenditure incurred in this stage shall be recognised as an expense when it is incurred.

¹ References to the *Framework* are to *Framework for the Preparation and Presentation of Financial Statements*, issued by the HKICPA in 1997. In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- 17 Once development of a web site is complete, an entity begins the activities described in the Operating stage. Subsequent expenditure to enhance or maintain an entity's own web site is recognised as an expense when incurred unless it meets the recognition criteria in IAS 38.18. IAS 38.20 explains that most subsequent expenditures are likely to maintain the future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria set out in IAS 38. In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will subsequent expenditure — expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset — be recognised in the carrying amount of an asset*.
- 18 An intangible asset is measured after initial recognition by applying the requirements of IAS 38.72-.87. The revaluation model in IAS 38.75 is applied only when the fair value of an intangible asset can be determined by reference to an active market.[†] However, as an active market is unlikely to exist for web sites, the cost model applies. Additionally, as indicated in IAS 38.92, many intangible assets are susceptible to technological obsolescence, and given the history of rapid changes in technology, the useful life of web sites will be short.

Date of Issue

December 2004

Effective Date

This Interpretation becomes effective for annual accounting periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies shall be accounted for in accordance with HKAS 8.

HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 5. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended the 'References' section and paragraph 6. An entity shall apply that amendment when it applies HKFRS 15.

This Interpretation supersedes Interpretation 19 *Intangible Asset – Website Costs* (issued in October 2002).

* The new text was added by IFRS 3 *Business Combinations* in 2004.

[†] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value. IFRS 13 defines an active market.