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

MEMBERS' HANDBOOK

Update No. 78

(Issued 19 February 2010)

Handbook Improvements only

Document Reference and Title	*Instructions*	*Explanations*

VOLUME II

Contents of Volume II	Insert the revised pages i and ii. Discard the replaced pages i and ii.	Revised contents pages

Amendments to the following Standards, Basis for Conclusions and Implementation Guidance were previously set out in the Appendix to the Standards as they were not yet effective. The Institute has taken this opportunity to incorporate the amendments applicable on 1 January 2010 in the relevant affected Standards, Basis for Conclusions and Implementation Guidance, for greater clarity.

Reference to HKAS/HKFRS contained in respective Implementation Guidance and Illustrative Examples are amended to IAS/IFRS to comply with relevant requirements contained in the International Accounting Standards Board license agreement.

HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)

HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*	Replace the cover page and pages 51 - 86 with revised cover page and pages 51 -86. Insert pages 26H – 26K after page 26G and pages 87 – 92 after page 86	Amendments due to - HKFRS 9 - *Improvements to HKFRSs 2008* - Editorial corrections to comply with IASB license agreement

HKFRS 2 *Share-based Payment*	Replace the Standard, Basis for Conclusions and Implementation Guidance with revised Standard, Basis for Conclusions and Implementation Guidance	Amendments due to - Amendments to HKFRS 2 – *Group Cash-settled Share-based Payment Transactions* - HKFRS 9 - Editorial corrections to comply with IASB license agreement
HKFRS 3 (Revised) *Business Combinations* (Standard)	Replace the cover page and page 3 with revised cover page and page 3. Insert page 43 after page 42	Amendments due to - HKFRS 9
HKFRS 3 (Revised) *Business Combinations* (Basis for Conclusions)	Replace the cover page and pages 5 and 97 with revised cover page and pages 5 and 97. Insert page 98 after page 97	Amendments due to - HKFRS 9
HKFRS 3 (Revised) *Business Combinations* (Illustrative Examples)	Replace the Illustrative Examples with revised Illustrative Examples	Amendments due to - Editorial corrections to comply with IASB license agreement
HKFRS 3 *Business Combinations* (Illustrative Examples)	Replace the Illustrative Examples with revised Illustrative Examples	Amendments due to - Editorial corrections to comply with IASB license agreement
HKFRS 4 *Insurance Contracts*	Replace the Standard, Basis for Conclusions and Implementation Guidance with revised Standard, Basis for Conclusions and Implementation Guidance	Amendments due to - HKAS 1 (Revised) - HKAS 27 (Revised) - HKFRS 3 (Revised) - Amendments to HKFRS 7 – *Improving Disclosures about Financial Instruments* - HKFRS 9 - Editorial corrections to comply with IASB license agreement

HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*	Replace the Standard, Basis for Conclusions and Implementation Guidance with revised Standard, Basis for Conclusions and Implementation Guidance	Amendments due to - HKAS 1 (Revised) - HKAS 27 (Revised) - HKFRS 3 (Revised) - HKFRS 8 - HK(IFRIC) – Int 17 - *Improvements to HKFRSs 2008* - *Improvements to HKFRSs 2009* - Editorial corrections to comply with IASB license agreement
HKFRS 6 *Exploration for and Evaluation of Mineral Resources*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKFRS 1 (Revised) - HKFRS 8 - *Improvements to HKFRSs 2009*

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

MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to February 2010)

		Issue/(Review date)
	PREFACE AND FRAMEWORK	
PREFACE	Preface to Hong Kong Financial Reporting Standards	10/06(12/07)
FRAMEWORK	Framework for the Preparation and Presentation of Financial Statements	9/04(12/07)
	HONG KONG ACCOUNTING STANDARDS (HKAS)	
HKAS 1	Presentation of Financial Statements	11/05(1/10)
HKAS 1 Revised	Presentation of Financial Statements	12/07 (1/10)
HKAS 2	Inventories	3/04(1/10)
HKAS 7	Statement of Cash Flows	12/04(1/10)
HKAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	9/04(1/10)
HKAS 10	Events after the Reporting Period	3/04(1/10)
HKAS 11	Construction Contracts	12/04(12/07)
HKAS 12	Income Taxes	11/04(7/09)
HKAS 14	Segment Reporting	11/04(3/08)
HKAS 16	Property, Plant and Equipment	11/05(10/08)
HKAS 17	Leases	12/04(5/09)
HKAS 18	Revenue	11/04(5/09)
HKAS 19	Employee Benefits	12/04(11/09)
HKAS 20	Accounting for Government Grants and Disclosure of Government Assistance	12/04(10/08)
HKAS 21	The Effects of Changes in Foreign Exchange Rates	3/04(10/08)
HKAS 23	Borrowing Costs	12/04(12/07)
HKAS 23 Revised	Borrowing Costs	6/07(10/08)
HKAS 24	Related Party Disclosures	12/04(11/09)
HKAS 24 Revised	Related Party Disclosures	11/09
HKAS 26	Accounting and Reporting by Retirement Benefit Plans	8/04
HKAS 27	Consolidated and Separate Financial Statements	11/05(3/08)
HKAS 27 Revised	Consolidated and Separate Financial Statements	3/08(12/08)
HKAS 28	Investments in Associates	3/04(10/08)

		Issue/(Review date)
HKAS 29	Financial Reporting in Hyperinflationary Economies	3/04(10/08)
HKAS 31	Interests in Joint Ventures	12/04(10/08)
HKAS 32	Financial Instruments: Presentation	11/04(10/09)
HKAS 33	Earnings per Share	3/04(3/08)
HKAS 34	Interim Financial Reporting	10/04(10/08)
HKAS 36	Impairment of Assets	8/04(5/09)
HKAS 37	Provisions, Contingent Liabilities and Contingent Assets	11/04(3/08)
HKAS 38	Intangible Assets	8/04(5/09)
HKAS 39	Financial Instruments: Recognition and Measurement	1/06(5/09)
HKAS 40	Investment Property	11/05(10/08)
HKAS 41	Agriculture	12/04(10/08)
	HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)	
HKFRS 1	First-time Adoption of Hong Kong Financial Reporting Standards	5/06(2/10)
HKFRS 1 Revised	First-time Adoption of Hong Kong Financial Reporting Standards	12/08(2/10)
HKFRS 2	Share-based Payment	4/04(2/10)
HKFRS 3	Business Combinations	11/05(2/10)
HKFRS 3 Revised	Business Combinations	3/08(2/10)
HKFRS 4	Insurance Contracts	3/06(2/10)
HKFRS 5	Non-current Assets Held for Sale and Discontinued Operations	8/04(2/10)
HKFRS 6	Exploration for and Evaluation of Mineral Resources	2/05(2/10)
HKFRS 7	Financial Instruments: Disclosures	9/05(2/10)
HKFRS 8	Operating Segments	3/07(11/09)
HKFRS 9	Financial Instruments	11/09(1/10)
IMPROVEMENTS TO HKFRSs	Improvements to HKFRSs	10/08
IMPROVEMENTS TO HKFRSs 2009	Improvements to HKFRSs 2009	5/09

HKFRS 1
Revised ~~October 2008~~February 2010

Effective for annual periods
beginning on or after 1 January 2004

Hong Kong Financial Reporting Standard 1

First-time Adoption of Hong Kong Financial Reporting Standards

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

Improvements to HKFRSs (issued in October 2008) — effective for annual periods beginning on or after 1 July 2009

Paragraph 34C(c) is amended and paragraph 47L is added (new text is underlined and deleted text is struck through).

Recognition and measurement

Exceptions to retrospective application of other HKFRSs

Non-controlling interests

34C A first-time adopter shall apply the following requirements of HKAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) prospectively from the date of transition to HKFRSs:

(a) ...

(c) the requirements in paragraphs 34–37 for accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of HKFRS 5.

...

Effective date

47L Paragraph 34C 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.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

Paragraphs 25A, 26 and 43A are amended and paragraph 25AA, a heading and paragraphs 34D–34G, a heading above paragraph 36D and paragraphs 36D, 36E and 47M are added.

25A HKAS 39 *Financial Instruments: Recognition and Measurement* permits a financial ~~asset~~ liability 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 provided it meets certain criteria. Despite this requirement, a first-time adopter of HKFRSs ~~exceptions apply in the following circumstances,~~

~~(a)~~ ~~any entity is permitted to make an available-for-sale designation at the date of transition to HKFRSs.~~

~~(b)~~ ~~*an entity that presents its first HKFRS financial statements for an annual period beginning on or after 1 September 2006—*such 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.

~~(c)~~ ~~*an entity that presents*~~ ...

~~(e)~~ ... ~~at the same time they are designated as at fair value through profit or loss.~~

25AA HKFRS 9 *Financial Instruments* permits a financial asset to be designated on initial recognition as a financial asset measured at fair value through profit or loss provided that the financial asset meets the criterion in paragraph 4.5 of HKFRS 9. Despite this requirement, a first-time adopter of HKFRSs is permitted to designate, at the date of transition to HKFRSs, any financial asset as measured at fair value through profit or loss provided the asset meets the criterion in paragraph 4.5 of HKFRS 9 at that date.

26 This HKFRS prohibits retrospective application of some aspects of other HKFRSs relating to:

(a) …

(d) assets classified as held for sale and discontinued operations (paragraphs 34A and 34B); ~~and~~

(e) some aspects of accounting for non-controlling interests (paragraph 34C)~~.~~; and

(f) classification and measurement of financial assets (paragraphs 34D–34G).

Classification and measurement of financial assets

34D An entity shall assess whether a financial asset meets the conditions in paragraph 4.2 of HKFRS 9 *Financial Instruments* on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

34E An entity may designate a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.5 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

34F An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.4.4 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

34G If it is impracticable (as defined in HKAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of HKAS 39, the fair value of the financial asset at the date of transition to HKFRSs shall be the new amortised cost of that financial asset at the date of transition to HKFRSs.

Exemption from the requirement to restate comparative information for HKFRS 9

36D In its first HKFRS financial statements, an entity that (a) adopts HKFRSs for annual periods beginning before 1 January 2012 and (b) applies HKFRS 9 shall present at least one year of comparative information. However, this comparative information need not comply with HKFRS 9 or HKFRS 7, to the extent that the disclosures required by HKFRS 7 relate to assets within the scope of HKFRS 9. For such entities, references to the 'date of transition to HKFRSs' shall mean, in the case of HKFRS 9 and HKFRS 7 only, the beginning of the first HKFRS reporting period.

36E An entity that chooses to present comparative information that does not comply with HKFRS 9 and HKFRS 7 in its first year of transition shall:

(a) apply the recognition and measurement requirements of its previous GAAP in place of the requirements of HKAS 39 and HKFRS 9 to comparative information about assets 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 9 and HKFRS 7) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)–(e) and (f)(i) of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* 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.

43A An entity is permitted to designate a previously recognised financial asset ~~or financial liability as a financial asset or financial liability~~ as measured at fair value through profit or loss in accordance with paragraph 25AA or a previously recognised financial liability as a financial liability at fair value through profit or loss ~~or a financial asset as available for sale~~ in accordance with paragraph 25A. The entity shall disclose the fair value of financial assets or financial liabilities so designated ~~into each category~~ at the date of designation and their classification and carrying amount in the previous financial statements.

47M HKFRS 9, issued in November 2009, amended paragraphs 25A, 26 and 43A and added paragraphs 25AA, 34D–34G, 36D and 36E. An entity shall apply those amendments when it applies HKFRS 9.

Guidance on Implementing

IFRS 1 First-time Adoption of International Financial Reporting Standards

Contents

	paragraphs
Introduction	**IG1**
~~SSAP~~IAS ~~9~~10 ***Events after the Balance Sheet Date***	**IG2-IG4**
~~SSAP~~IAS 12 ***Income Taxes***	**IG5-IG6**
~~SSAP~~IAS 16 ***Property, Plant and Equipment***	**IG7-IG13**
~~SSAP~~IAS ~~14~~17 ***Leases***	**IG14-IG16**
~~SSAP~~IAS 18 ***Revenue***	**IG17**
~~SSAP~~IAS ~~34~~19 ***Employee Benefits***	**IG18-IG21**
IAS 21 ***The Effects of Changes in Foreign Exchange Rates***	**IG21A**
~~SSAP 30~~ IFRS 3 ***Business Combinations***	**IG22**
~~SSAP~~ IAS ~~19~~23 ***Borrowing Costs***	**IG23-IG25**
~~SSAP~~IAS ~~32~~27 ***Consolidated and Separate Financial Statements ~~and Accounting for Investments in Subsidiaries~~***	**IG26-IG31**
IAS 29 ***Financial Reporting in Hyperinflationary Economies***	**IG32-IG34**
IAS 32 ***Financial Instruments: Disclosure and Presentation***	**IG35-IG36**
~~SSAP~~IAS ~~25~~34 ***Interim Financial Reporting***	**IG37-IG38**
~~SSAP~~ IAS ~~31~~36 ***Impairment of Assets and ~~SSAP 28~~IAS 37 Provisions, Contingent Liabilities and Contingent Assets***	**IG39-IG43**
~~SSAP 29~~ IAS 38 ***Intangible Assets***	**IG44-IG51**
~~SSAP 24 Accounting for Investments in Securities~~	**~~IG51A-51F~~**
IAS 39 ***Financial Instruments: Recognition and Measurement***	**IG52-IG60B**
Recognition	IG53-IG54
Embedded derivatives	IG55
Measurement	IG56-IG58
Transition adjustments	IG58A-IG59
Hedge accounting	IG60-IG60B
~~SSAP 13~~ IAS 40 ~~Accounting for~~ ***Investment ~~Properties~~Property***	**IG61-IG62**
Explanation of transition to IFRSs	**IG63**

IFRS 2 ***Share-based Payment*** **IG64-IG65**

IFRIC INTERPRETATIONS

IFRIC 1 ***Changes in Existing Decommissioning, Restoration and Similar Liabilities*** **IG201-IG203**

IFRIC 4 ***Determining whether an Arrangement contains a Lease*** **IG204-IG205**

APPENDIX

Amendments resulting from other Implementation Guidance

List of examples

1	**Estimates**	**IG3**
2	**Business combination**	**IG22**
3	**Business combination-restructuring provision**	**IG22**
4	**Business combination-intangible assets**	**IG22**
5	**Business combination-goodwill deducted from equity and treatment of related intangible assets**	**IG22**
6	**Business combination-subsidiary not consolidated under previous GAAP**	**IG22**
7	**Business combination-finance lease not capitalised under previous GAAP**	**IG22**
8	**Parent adopts IFRSs before subsidiary**	**IG29**
9	**Subsidiary adopts IFRSs before parent**	**IG29**
10	**Interim financial reporting**	**IG38**
11	**Reconciliations of equity and profit or loss**	**IG63**
201	**Changes in existing decommissioning, restoration and similar liabilities**	**IG203**
202	**Determining whether an arrangement contains a lease**	**IG205**

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). 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 39(a) and (b), 40 and 41 of the IFRS (paragraph IG63).

~~SSAP~~ IAS ~~9~~10 *Events after the Balance Sheet Date*

IG2 Except as described in paragraph IG3, an entity applies ~~SSAP 9~~ IAS 10 in determining whether:

(a) its opening IFRS balance sheet reflects an event that occurred after the date of transition to IFRSs; and

(b) comparative balance sheet amounts in its first IFRS financial statements reflect an event that occurred after the end of that comparative period.

IG3 Paragraphs 31-34 of the IFRS require some modifications to the principles in ~~SSAP~~ IAS ~~9~~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 31-34 of the IFRS do not require modifications to the principles in ~~SSAP~~ IAS ~~9~~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 under IFRSs need to be consistent with estimates made for that date under previous GAAP, unless there is objective evidence that those estimates were in error (see ~~SSAP 2 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies~~ 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 under IFRSs. In this case, the estimates under IFRSs need to be consistent with the estimates required under 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 balance sheet 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 ~~SSAP 28~~ 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 under previous GAAP as inputs in making the discounted measurement required by ~~SSAP 28~~IAS 37.

(c) Case 3. Previous GAAP did not require estimates of similar items for the date of transition to IFRSs. Estimates under 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 ~~SSAP 28~~ IAS 10 between adjusting events after the balance sheet date and non-adjusting events after the balance sheet date.

IG Example 1: Estimates

BACKGROUND

Entity A's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for one year. In its previous GAAP financial statements for 31 December 2003 and 2004, 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 2004. When the court case was concluded on 30 June 2005, entity A was required to pay 1,000 and paid this on 10 July 2005.

In preparing its first IFRS financial statements, entity A concludes that its estimates under previous GAAP of accrued expenses and provisions at 31 December 2003 and 2004 were made on a basis consistent with its accounting policies under 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 over- and underestimates involves the routine adjustment of estimates under ~~SSAP 2.~~IAS 8.

APPLICATION OF REQUIREMENTS

In preparing its opening IFRS balance sheet at 1 January 2004 and in its comparative balance sheet at 31 December 2004, 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 under ~~SSAP 34~~ IAS 19 *Employee Benefits*. Entity A's actuarial assumptions at 1 January 2004 and 31 December 2004 do not reflect conditions that arose after those dates. For example, entity A's:

    (i) discount rates at 1 January 2004 and 31 December 2004 for the pension plan and for provisions reflect market conditions at those dates; and

(ii) actuarial assumptions at 1 January 2004 and 31 December 2004 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 2005.

The treatment of the court case at 31 December 2004 depends on the reason why entity A did not recognise a provision under previous GAAP at that date.

ASSUMPTION 1 - Previous GAAP was consistent with ~~SSAP 28~~ 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 under IFRSs are consistent with its assumptions under previous GAAP. Therefore, entity A does not recognise a provision at 31 December 2004.

ASSUMPTION 2 - Previous GAAP was not consistent with ~~SSAP 28~~IAS 37. Therefore, entity A develops estimates under ~~SSAP 28~~IAS 37. Under ~~SSAP 28~~IAS 37, an entity determines whether an obligation exists at the balance sheet date by taking account of all available evidence, including any additional evidence provided by events after the balance sheet date. Similarly, under ~~SSAP 9~~ IAS 10 *Events after the Balance Sheet Date*, the resolution of a court case after the balance sheet date is an adjusting event after the balance sheet date 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 2004 (when the events occurred that gave rise to the court case). Therefore, entity A recognises a provision at 31 December 2004. Entity A measures that provision by discounting the 1,000 paid on 10 July 2005 to its present value, using a discount rate that complies with ~~SSAP 28~~ IAS 37 and reflects market conditions at 31 December 2004.

IG4 Paragraphs 31-34 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 ~~SSAP~~IAS 17 ~~14~~ *Leases*);

(b) the restrictions in ~~SSAP 29~~ 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: Disclosure and Presentation*[1]).

~~SSAP~~ IAS 12 *Income Taxes*

IG5 An entity applies ~~SSAP~~ IAS 12 to temporary differences between the carrying amount of the assets and liabilities in its opening IFRS balance sheet and their tax bases.

IG6 Under ~~SSAP~~ IAS 12, the measurement of current and deferred tax reflects tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. An entity accounts for the effect of changes in tax rates and tax laws when those changes are enacted or substantively enacted.

~~[1] At the time of issue of this IFRS, a proposed SSAP based on the IASB's proposed revision to IAS 32 has been issued as an exposure draft. In accordance with paragraph 23 of SSAP 1, management should consider IAS 32 when accounting for a financial liability or an equity instrument. Notwithstanding this, until the proposed SSAP based on IAS 32 becomes effective, IG4 is only relevant to those first-time adopters that elect to adopt the treatment under IAS 32.~~

~~SSAP~~ IAS ~~17~~16 *Property, Plant and Equipment*

IG7 If an entity's depreciation methods and rates under previous GAAP are acceptable under IFRSs, it accounts for any change in estimated useful life or depreciation pattern prospectively from when it makes that change in estimate (paragraphs 31 and 32 of the IFRS and paragraph ~~54~~61 of ~~SSAP~~IAS ~~17~~16). However, in some cases, an entity's depreciation methods and rates under previous GAAP may differ from those that would be acceptable under 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 balance sheet 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 16 of the IFRS), in which case the entity gives the disclosures required by paragraph 44 of the IFRS;

(b) a revaluation under previous GAAP that meets the criteria in paragraph 17 of the IFRS; or

(c) fair value at the date of an event such as a privatisation or initial public offering (paragraph 19 of the IFRS).

IG9 Subsequent depreciation is based on that deemed cost and starts from the date for which the entity established the fair value measurement or revaluation.

IG10 ~~If an entity adopts the allowed alternative treatment in SSAP 17 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 44 of the IFRS.~~ 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 44 of the IFRS.

IG11 If revaluations under previous GAAP did not satisfy the criteria in paragraph 17 or 19 of the IFRS, an entity measures the revalued assets in its opening balance sheet 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 ~~SSAP 17 benchmark treatment~~;

~~(b) deemed cost, being the fair value at the date of transition to IFRSs (paragraph 16 of the IFRS); or~~ deemed cost, being the fair value at the date of transition to IFRSs (paragraph 16 of the IFRS); or

~~(c) revalued amount, if the entity adopts the SSAP 17 allowed alternative treatment as its accounting policy under IFRSs for all assets in the same class.~~ revalued amount, if the entity adopts the revaluation model in IAS 16 as its accounting policy under IFRSs for all items of property, plant and equipment in the same class.

IG12 ~~Some assets are made up of components that have different useful lives or provide benefits to the entity in different patterns. Under SSAP 17, the entity accounts for these components as separate assets (see SSAP 17, paragraphs 13 and 27 to 29).~~ IAS 16 requires each part of an item of property, plant equipment with a cost that is significant in relation to the 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 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 ~~SSAP 28~~ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in recognising and measuring any resulting provision. The entity applies ~~SSAP 17~~ 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 provision 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 25E 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.

~~SSAP 14~~ 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 (~~SSAP 14~~IAS 17, paragraph ~~10~~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 under ~~SSAP 14~~ 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 ~~SSAP 14~~ IAS 17 was ~~revised~~ issued in ~~2000~~2004, the net cash investment method for recognising finance income of lessors was eliminated. ~~SSAP 14~~ IAS 17 permits finance lessors to eliminate this method prospectively. However, the transitional provisions in ~~SSAP 14~~ IAS 17 do not apply to an entity's opening IFRS balance sheet (paragraph 9 of the IFRS). Therefore, a finance lessor measures finance lease receivables in its opening IFRS balance sheet as if the net cash investment method had never been permitted.

IG16 ~~SSAP 14 paragraphs 27, 28, 48 and 49~~SIC-15 *Operating Leases - Incentives*, dealing with the accounting of an incentive arising from an operating lease, apply to lease terms beginning on or after 1 ~~July 2000~~January 2005. However, a first-time adopter applies those paragraphs to all leases, whether they started before or after that date.

~~SSAP~~IAS 18 *Revenue*

IG17 If an entity has received amounts that do not yet qualify for recognition as revenue under ~~SSAP~~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 balance sheet and measures that liability at the amount received.

IAS 19 *Employee Benefits*

IG18 At the date of transition to IFRSs, an entity applies IAS 19 in measuring net employee benefit assets or liabilities under defined benefit plans, but it may elect to recognise all cumulative actuarial gains or losses from the inception of the plan until the date of transition to IFRSs even if its accounting policy under IAS 19 will involve leaving some later actuarial gains and losses unrecognised (paragraph 20 of the IFRS). The transitional provisions in IAS 19 do not apply to an entity's opening IFRS balance sheet (paragraph 9 of the IFRS).

IG19 An entity's actuarial assumptions at the date of transition to IFRSs are consistent with actuarial assumptions made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 31 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 under 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 ~~32~~33 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 reporting date, the date of the comparative balance sheet 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, under 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 B 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 have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2001, entity B acquired 100 per cent of subsidiary C. Under 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 under previous GAAP at 31 December 2003 (date of transition to IFRSs):

- (i) identifiable assets less liabilities for which IFRSs require cost-based measurement at a date after the business combination: 200 (with a tax base of 150 and an applicable tax rate of 30 per cent).
- (ii) pension liability (for which the present value of the defined benefit obligation measured under ~~SSAP 34~~ IAS 19 *Employee Benefit*s is 130 and the fair value of plan assets is 100): nil (because entity B used a pay-as-you-go cash method of accounting for pensions under its previous GAAP). The tax base of the pension liability is also nil.
- (iii) goodwill: 180.

(c) did not, at the date of acquisition, recognise deferred tax arising from temporary differences associated with the identifiable assets acquired and liabilities assumed.

APPLICATION OF REQUIREMENTS

In its opening (consolidated) IFRS balance sheet, entity B:

(a) classifies the business combination as an acquisition by entity B even if the business combination would have qualified under ~~SSAP 30~~ IFRS 3 as a reverse acquisition by subsidiary C (paragraph B2(a) of the IFRS).

(b) does not adjust the accumulated amortisation of goodwill. Entity B tests the goodwill for impairment under ~~SSAP 31~~ 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 180 (paragraph B2(g)).

(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 under previous GAAP immediately after the business combination as their deemed cost at that date (paragraph B2(e)).

(d) does not restate the accumulated depreciation and amortisation of the net identifiable assets in (c), unless the depreciation methods and rates under previous GAAP result in amounts that differ materially from those required under IFRSs (for example, if they were adopted solely for tax purposes and do not reflect a reasonable estimate of the asset's useful life under IFRSs). If no such restatement is made, the carrying amount of those assets in the opening IFRS balance sheet equals their carrying amount under previous GAAP at the date of transition to IFRSs (200) (paragraph IG7).

(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 ~~SSAP 31~~ IAS 36 *Impairment of Assets*).

(f) recognises the pension liability, and measures it, at the present value of the defined benefit obligation (130) less the fair value of the plan assets (100), giving a carrying amount of 30, with a corresponding debit of 30 to retained earnings (paragraph B2(d)). 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 separate financial statements (paragraph 25 of the IFRS and IG Example 9).

(g) recognises a net deferred tax liability of 6 (20 at 30 per cent) arising from:

   (i) the taxable temporary difference of 50 (200 less 150) associated with the identifiable assets acquired and non-pension liabilities assumed, less

   (ii) the deductible temporary difference of 30 (30 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 B2(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 ~~SSAP~~ IAS 12 *Income Taxes*).

IG Example 3: Business combination – restructuring provision

BACKGROUND

Entity D's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2003, entity D acquired 100 per cent of subsidiary E. Under its previous GAAP, entity D recognised an (undiscounted) restructuring provision of 100 that would not have qualified as an identifiable liability under IFRS 3. The recognition of this restructuring provision increased goodwill by 100. At 31 December 2003 (date of transition to IFRSs), entity D:

(a) had paid restructuring costs of 60; and

(b) estimated that it would pay further costs of 40 in 2004, and that the effect of discounting were immaterial. At 31 December 2003, those further costs did not qualify for recognition as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

APPLICATION OF REQUIREMENTS

In its opening IFRS balance sheet, entity D:

(a) does not recognise a restructuring provision (paragraph B2(c) of the IFRS).

(b) does not adjust the amount assigned to goodwill. However, entity D tests the goodwill for impairment under IAS 36 *Impairment of Assets*, and recognises any resulting impairment loss (paragraph B2(g)).

(c) as a result of (a) and (b), reports retained earnings in its opening IFRS balance sheet that are higher by 40 (before income taxes, and before recognising any impairment loss) that in the balance sheet at the same date under previous GAAP.

IG Example 4: Business combination – intangible assets

BACKGROUND

Entity F's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2001, entity F acquired 75 per cent of subsidiary G. Under its previous GAAP, entity F assigned an initial carrying amount of 200 to intangible assets that would not have qualified for recognition under ~~SSAP 29~~ 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 60. ~~Under SSAP 30 *Business Combinations*, entity F measured minority interests at the minority's share of the fair value of the identifiable net assets acquired.~~

On 31 December 2003 (the date of transition to IFRSs), the carrying amount of the intangible assets under previous GAAP was 160, and the carrying amount of the related deferred tax liability was 48 (30 per cent of 160).

APPLICATION OF REQUIREMENTS

Because the intangible assets do not qualify for recognition as separate assets under ~~SSAP 29~~IAS 38, entity F transfers them to goodwill, together with the related deferred tax liability (48) and minority interests (paragraph B2(g)(i) of the IFRS). The related minority interests amount to 28 (25 per cent of [160 - 48 = 112]). Thus, the increase in goodwill is 84 – intangible assets (160) less deferred tax liability (48) less minority interests (28).

Entity F tests the goodwill for impairment under ~~SSAP 31~~ IAS 36 *Impairment of Assets* and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRSs (paragraph B2(g)(iii) 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. Under 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 under ~~SSAP 29~~IAS 38; and

(c) did not recognise an intangible asset of the subsidiary that would qualify under ~~SSAP 29~~ IAS 38 *Intangible Assets* 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 balance sheet, entity H:

(a) does not recognise the goodwill, as it did not recognise the goodwill as an asset under previous GAAP (paragraph B2(g)-B2(i)).

(b) does not recognise the intangible asset that does not qualify for recognition as an asset under ~~SSAP 29~~IAS 38. Because entity H deducted goodwill from equity under its previous GAAP, the elimination of this intangible asset reduces retained earnings (paragraph B2(c)(ii)).

(c) recognises the intangible asset that qualifies under ~~SSAP 29~~IAS 38 for recognition as an asset in the separate financial statements of the subsidiary, even though the amount assigned to it under previous GAAP in entity H's consolidated financial statements was nil (paragraph B2(f)). The recognition criteria in ~~SSAP 29~~ 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 under ~~SSAP 31~~ IAS 36. Because entity H deducted goodwill from equity under its previous GAAP, the recognition of this intangible asset increases retained earnings (paragraph B2(c)(ii)). However, if this intangible asset had been subsumed in goodwill recognised as an asset under previous GAAP, entity H would have decreased the carrying amount of that goodwill accordingly (and, if applicable, adjusted deferred tax and minority interests) (paragraph B2(g)(i)).

IG Example 6: Business combination – subsidiary not consolidated under previous GAAP

BACKGROUND

Parent J's date of transition to IFRSs is 1 January 2004. Under its previous GAAP, parent J did not consolidate its 75 per cent subsidiary K, acquired in a business combination on 15 July 2001. On 1 January 2004:

(a) the cost of parent J's investment in subsidiary K is 180.

(b) under IFRSs, subsidiary K would measure its assets at 500 and its liabilities (including deferred tax under ~~SSAP 12~~IAS 12) at 300. On this basis, subsidiary K's net assets are 200 under IFRSs.

APPLICATION OF REQUIREMENTS

Parent J consolidates subsidiary K. The consolidated balance sheet at 1 January 2004 includes:

(a) subsidiary K's assets at 500 and liabilities at 300;

(b) minority interests of 50 (25 per cent of [500-300]); and

(c) goodwill of 30 (cost of 180 less 75 per cent of [500-300]) (paragraph B2(j)). Parent J tests the goodwill for impairment under ~~SSAP 31~~ IAS 36 *Impairment of Assets* and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRSs (paragraph B2(g)(iii)).

IG Example 7: Business combination – finance lease not capitalised under previous GAAP

BACKGROUND

Parent L's date of transition to IFRSs is 1 January 2004. Parent L acquired subsidiary M on 15 January 2001 and did not capitalise subsidiary M's finance leases. If subsidiary M prepared separate financial statements under IFRSs, it would recognise finance lease obligations of 300 and leased assets of 250 at 1 January 2004.

APPLICATION OF REQUIREMENTS

In its consolidated opening IFRS balance sheet, parent L recognises finance lease obligations of 300 and leased assets of 250, and charges 50 to retained earnings (paragraph B2(f)).

~~SSAP 19~~ IAS 23 *Borrowing Costs*

IG23 On first adopting IFRSs, an entity adopts a policy of capitalising borrowing costs (IAS 23 allowed alternative treatment) or not capitalising them (IAS 23 benchmark treatment). The entity applies that policy consistently in its opening IFRS balance sheet and in all periods presented in its first IFRS financial statements. 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 Under the allowed alternative treatment, ~~SSAP 19~~ IAS 23 requires disclosure of interest capitalised during the period. Neither ~~SSAP 19~~ IAS 23 nor the IFRS requires disclosure of the cumulative amount capitalised.

IG25 ~~SSAP 19~~ IAS 23 contains transitional provisions that encourage retrospective application, but permit an entity that adopts the allowed alternative treatment to capitalise (prospectively) only those borrowing costs incurred after the effective date of ~~SSAP 19~~ IAS 23 that meet the criteria for capitalisation. However, if a first time adopter adopts the IAS 23 allowed alternative treatment, the IFRS requires retrospective application even for periods before the effective date of ~~SSAP 19~~ IAS 23 (paragraph 9 of the IFRS).

~~SSAP 32~~ IAS 27 *Consolidated and Separate Financial Statements* ~~*and Accounting for Investments in Subsidiaries*~~

IG26 A first-time adopter consolidates all subsidiaries that it controls, unless ~~SSAP 32~~ IAS 27 requires otherwise.

IG27 If a first-time adopter did not consolidate a subsidiary under 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 separate 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 25 of the IFRS). If the subsidiary has not adopted IFRSs in its separate financial statements, the carrying amounts described in the previous sentence are those that IFRSs would require in those separate financial statements (paragraph B2(j) of the IFRS).

(b) if the parent acquired the subsidiary in a business combination before the date of transition to IFRS, the parent recogises 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 balance sheet, this may affect minority interests and deferred tax.

IG29 IG Examples 8 and 9 illustrate paragraphs 24 and 25 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 2005. Its foreign subsidiary O, wholly owned by parent N since formation, prepares information under IFRSs for internal consolidation purposes from that date, but subsidiary O does not present its (separate) first IFRS financial statements until 2007.

APPLICATION OF REQUIREMENTS

If subsidiary O applies paragraph 24(a) of the IFRS, the carrying amounts of its assets and liabilities are the same in both its (separate) opening IFRS balance sheet at 1 January 2006 and parent N's consolidated balance sheet (except for adjustments for consolidation procedures) and are based on parent N's date of transition to IFRSs.

Alternatively, subsidiary O may, under paragraph 24(b) of the IFRS, measure all its assets or liabilities based on its own date of transition to IFRSs (1 January 2006). However, the fact that subsidiary O becomes a first-time adopter in 2007 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 2007. Its foreign subsidiary Q, wholly owned by parent P since formation, presented its (separate) first IFRS financial statements in 2005. Until 2007, subsidiary Q prepared information for internal consolidation purposes under parent P's previous GAAP.

APPLICATION OF REQUIREMENTS

The carrying amounts of subsidiary Q's assets and liabilities at 1 January 2006 are the same in both parent P's (consolidated) opening IFRS balance sheet and subsidiary Q's separate 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 2007 does not change those carrying amounts (paragraph 25 of the IFRS).

IG30 Paragraphs 24 and 25 of the IFRS do not override the following requirements:

(a) to apply Appendix B 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 25 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 24 and 25 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 24 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 under IFRSs for consolidation purposes but did not present a full set of financial statements under 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 post-balance sheet events review and central allocation of pension costs. For the disclosure required by paragraph 41 of the IFRS, adjustments made centrally to an unpublished reporting package are not corrections of errors. However, paragraph 24 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*[2]

IG32 ~~An entity complies with IAS 21The Effects of Changes in Foreign Exchange Rates in determining its measurement currency and presentation currency (see SIC-19 Reporting Currency--Measurement and Presentation of Financial Statements under IAS 21 and IAS 29). When the entity prepares its opening IFRS balance sheet, it applies IAS 292 to any periods during which the economy of the measurement currency or presentation currency was hyperinflationary.~~ 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 balance sheet, 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 16 of the IFRS), in which case it gives the disclosures required by paragraph 44 of the IFRS.

IG34 If an entity elects to use the exemptions in paragraphs 16-19 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: Disclosure and Presentation*[3]

IG35 In its opening IFRS balance sheet, 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 ~~18~~15 and ~~26~~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 26). An entity determines those carrying amounts using the version of IAS 32 effective at the reporting date for its first IFRS financial statements. 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~~

2 ~~At the time of issue of this IFRS, proposed SSAPs based on IAS 29 and the IASB's proposed revised IAS 21 (included in the IASB's Exposure Draft "Improvements to International Accounting Standards") have been issued as exposure drafts. In accordance with paragraph 23 of SSAP 1, management should consider IAS 21 and IAS 29. Notwithstanding this, until the proposed SSAPs based on IAS 21 and IAS 29 become effective, IG32-IG34 are only relevant to those first-time adopters that elect to follow IAS 21 and IAS 29.~~

3 ~~At the time of issue of this IFRS, a proposed SSAP based on the IASB's proposed revision to IAS 32 has been issued as an exposure draft. In accordance with paragraph 23 of SSAP 1, management should consider IAS 32 when accounting for a financial instrument. Notwithstanding this, until the proposed SSAP based on IAS 32 becomes effective, IG 35 and IG 36 are only relevant to those first-time adopters that elect to follow IAS 32.~~

~~accreted on the liability component (paragraph 23 of the IFRS).~~ 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 reporting date for its first IFRS financial statements. 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 28 of the IFRS).

~~SSAP 25~~ IAS 34 *Interim Financial Reporting*

IG37 ~~SSAP 25~~ IAS 34 applies if an entity is required, or elects, to present an interim financial report in accordance with IFRSs. Accordingly, neither ~~SSAP 25~~ IAS 34 nor the IFRS requires an entity:

(a) to present interim financial reports that comply with ~~SSAP 25~~IAS 34; or

(b) to prepare new versions of interim financial reports presented under previous GAAP. However, if an entity does prepare an interim financial report under ~~SSAP 25~~ 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 under ~~SSAP 25~~ IAS 34 for part of the period covered by its first IFRS financial statements. In particular, paragraph 45 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 have a reporting date of 31 December 2005, and its first interim financial report under ~~SSAP 25~~ IAS 34 is for the quarter ended 31 March 2005. Entity R prepared previous GAAP annual financial statements for the year ended 31 December 2004, and prepared quarterly reports throughout 2004.

APPLICATION OF REQUIREMENTS

In each quarterly interim financial report for 2005, entity R includes reconciliations of:

(a) its equity under previous GAAP at the end of the comparable quarter of 2004 to its equity under IFRSs at that date; and

(b) its profit or loss under previous GAAP for the comparable quarter of 2004 (current and year-to-date) to its profit or loss under IFRSs.

In addition to the reconciliations required by (a) and (b) and the disclosures required by ~~SSAP 25~~IAS 34, entity R's interim financial report for the first quarter of 2005 includes reconciliations of (or a cross-reference to another published document that includes these reconciliations):

(a) its equity under previous GAAP at 1 January 2004 and 31 December 2004 to its equity under IFRSs at those dates; and

(b) its profit or loss for 2004 under previous GAAP to its profit or loss for 2004 under IFRSs.

Each of the above reconciliations gives sufficient detail to enable users to understand the material adjustments to the balance sheet and income statement. Entity R also explains the material adjustments to the cash flow statement.

If entity R becomes aware of errors made under 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 under previous GAAP, disclose information material to an understanding of the current interim period, its interim financial reports for 2005 disclose that information or include a cross-reference to another published document that includes it (paragraph 46 of the IFRS).

~~SSAP 31~~ IAS 36 *Impairment of Assets* and ~~SSAP 28~~ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

IG39 An entity applies ~~SSAP 31~~ 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 ~~SSAP 31~~ 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 39(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 under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error (paragraphs 31 and 32 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 under its previous GAAP. Such estimates and assumptions do not reflect conditions that arose after the date of transition to IFRSs (paragraph 33 of the IFRS).

IG42 The transitional provisions in ~~SSAP 31~~ IAS 36 and ~~SSAP 28~~IAS 37 do not apply to an entity's opening IFRS balance sheet (paragraph 9 of the IFRS).

IG43 ~~SSAP 31~~ IAS 36 requires the reversal of impairment losses in some cases. If an entity's opening IFRS balance sheet reflects impairment losses, the entity recognises any later reversal of those impairment losses in the income statement (except when ~~SSAP 31~~IAS 36 requires the entity to treat that reversal as a revaluation). This applies

to both impairment losses recognised under previous GAAP and additional impairment losses recognised on transition to IFRSs.

~~SSAP 29~~ IAS 38 *Intangible Assets*

IG44 An entity's opening IFRS balance sheet:

(a) excludes all intangible assets and other intangible items that do not meet the criteria for recognition under ~~SSAP 29~~ IAS 38 at the date of transition to IFRSs; and

(b) includes all intangible assets that meet the recognition criteria in ~~SSAP 29~~ IAS 38 at that date, except for intangible assets acquired in a business combination that were not recognised in the acquirer's consolidated balance sheet under previous GAAP and also would not qualify for recognition under ~~SSAP 29~~ IAS 38 in the separate balance sheet of the acquiree (see paragraph B2(f) of Appendix B of the IFRS).

IG45 The criteria in ~~SSAP 29~~ 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.

~~SSAP 29~~ IAS 38 supplements these two criteria with further, more specific, criteria for internally generated intangible assets.

IG46 Under paragraphs ~~53~~65 and ~~59~~71 of ~~SSAP 29~~IAS 38, an entity capitalises the costs of creating internally generated intangible assets prospectively from the date when the recognition criteria are met. ~~SSAP 29~~ 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, ~~SSAP 29~~ 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 balance sheet even if it had recognised the related expenditure as an expense under previous GAAP. If the asset does not qualify for recognition under ~~SSAP 29~~ 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 ~~23~~26 of ~~SSAP 29~~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 under previous GAAP immediately after the business combination is its deemed cost under IFRSs at that date (paragraph B2(e) of the IFRS). If that carrying amount was zero, the acquirer does not recognise the intangible asset in its consolidated opening IFRS balance sheet, unless it would qualify under ~~SSAP 29~~ IAS 38, applying the criteria discussed in paragraphs IG45-IG48, for recognition at the date of transition to IFRSs in the separate balance sheet of the acquiree (paragraph B2(f) of the IFRS). If those recognition criteria are met, the acquirer measures the asset on the basis that ~~SSAP 29~~ IAS 38 would require in the separate balance sheet of the acquiree. The resulting adjustment affects goodwill (paragraph B2(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 19 of the IFRS), provided that the intangible asset qualifies for recognition under ~~SSAP 29~~ IAS 38 (paragraph 10 of the IFRS). In addition, if, and only if, an intangible asset meets both the recognition criteria in ~~SSAP 29~~ IAS 38 (including reliable measurement of original cost) and the criteria in ~~SSAP 29~~ 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 18 of the IFRS):

(a) fair value at the date of transition to IFRSs (paragraph 16 of the IFRS), in which case the entity gives the disclosures required by paragraph 44 of the IFRS; or

(b) a revaluation under previous GAAP that meets the criteria in paragraph 17 of the IFRS.

IG51 If an entity's amortisation methods and rates under previous GAAP would be acceptable under IFRSs, the entity does not restate the accumulated amortisation in its opening IFRS balance sheet. 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 31 of the IFRS and paragraph 94 of ~~SSAP 29~~IAS 38). However, in some cases, an entity's amortisation methods and rates under previous GAAP may differ from those that would be acceptable under 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 balance sheet retrospectively so that it complies with IFRSs (paragraph 31 of the IFRS).

~~SSAP 24 Accounting for Investments in Securities~~

~~IG51A An entity applies SSAP 24 when accounting and reporting for investments in debt and equity securities, except those held either solely for the purpose of recovering advances, or as investments in subsidiaries, associates or joint ventures which are dealt with in accordance with SSAP 32, SSAP 10 and SSAP 21 respectively.~~

~~IG51B In preparing its opening IFRS balance sheet, an entity applies the criteria in SSAP 24 to identify those securities that are measured at amortised cost, those that are measured at cost and those that are measured at fair value. In particular:~~

~~(a) to comply with SSAP 24, paragraph 10, classification of securities as held-to-maturity securities relies on a designation made by the entity in applying SSAP 24 reflecting the entity's intention and ability at the date of transition to IFRSs. It follows that sales or transfers of held-to-maturity securities before the date of transition to IFRSs do not trigger the 'tainting' rules in SSAP 24, paragraph 14.~~

~~(b) to comply with SSAP 24, paragraph 19, an entity adopting the benchmark treatment under SSAP 24 classifies an investment other than a held-to-maturity security in its opening IFRS balance sheet as an investment security if, and only if:~~

~~(i) the security is held for an identified long term purpose;~~

~~(ii) that purpose was documented at the date of acquisition or change of purpose; and~~

~~(iii) the security held for the documented purpose is clearly identifiable.~~

~~If the security does not meet the above criteria, it should be treated as other investment.~~

~~(c) to comply with SSAP 24, paragraph 27, an entity adopting the alternative treatment under SSAP 24 classifies an investment other than a held-to maturity security in its opening IFRS balance as a security held for trading purposes if, and only if the security was acquired principally for the purpose of generating a profit from short-term fluctuation in price or dealer's margin. If the security does not meet the criteria for classifying as a security held for trading purposes, it should be treated as a security that is not held for trading purposes.~~

~~IG51C For held-to-maturity securities measured at amortised cost, and for investment securities carried at cost under the benchmark treatment for investments other than held-to-maturity securities, in the opening IFRS balance sheet an entity determines their cost on the basis of circumstances existing when the securities first satisfied the recognition criteria in SSAP 24. However, if the entity acquired those securities in a past business combination, their carrying amount under previous GAAP immediately following the business combination is their deemed cost under IFRSs at that date (paragraph B2(e) of the IFRS).~~

~~IG51D For those securities measured at fair value with the changes in fair value being recognised in equity (i.e. securities that are not held for trading purposes under the alternative treatment of SSAP 24), an entity recognises the cumulative changes in their fair value at the date of transition to IFRSs in a separate component of equity, rather than in retained earnings. On subsequent sale, collection, disposal or impairment of the securities, the entity transfers to the income statement the cumulative gain or loss previously recognised in equity (paragraph 28(b) of SSAP 24.)~~

~~IG51E An entity applies SSAP 24, paragraphs 31 to 39 in:~~

~~(a) determining whether any impairment loss exists in respect of the securities measured at amortised cost or cost at the date of transition to IFRSs; and~~

~~(b) measuring any impairment loss that exists in respect of those securities at that date, and reversing any impairment loss that no longer exists at that date.~~

~~IG51F An entity's estimates of impairments of those securities measured at amortised cost or cost at the date of transition to IFRSs are consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 31 of the IFRS). The entity treats the impact of any later revisions to those estimates as impairment losses (or if the criteria in SSAP 24 are met, reversals of impairment losses) of the period in which it makes the revisions.~~

IAS 39 *Financial Instruments: Recognition and Measurement*[4]

IG52 ~~An entity recognises and measures all financial assets and financial liabilities in its opening IFRS balance sheet in accordance with IAS 39, except as specified in paragraphs 27-30 of the IFRS, which address derecognition and hedge accounting.~~ An entity recognises and measures all financial assets and financial liabilities in its opening IFRS balance sheet in accordance with IAS 39, except as specified in paragraphs 27-30 of the IFRS, which address derecognition and hedge accounting, and paragraph 36A, which permits an exemption from restating comparative information.

Recognition

IG53 ~~An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition under IAS 39 and have not yet qualified for derecognition under IAS 39, except financial assets or financial liabilities derecognised under previous GAAP in a financial year beginning before 1 January 2001 (see paragraph 27 of the IFRS).~~ An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition under IAS 39 and have not yet qualified for derecognition under IAS 39, except non-derivative financial assets and non-derivative financial liabilities derecognised under previous GAAP before 1 January 2004, to which the entity does not choose to apply paragraph 27A (see paragraphs 27 and 27A of the IFRS). For example, an entity that does not apply paragraph 27A does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred before 1 January 2004 if those transactions qualified for derecognition under previous GAAP. However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after 1 January 2004, those further transfers qualify for derecognition only if they meet the derecognition criteria of IAS 39.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition under IAS 39, or have already qualified for derecognition under IAS 39.

Embedded derivatives

IG55 ~~When IAS 39 requires an entity to separate an embedded derivative from a host contract, their initial carrying amounts at the date when the instrument first satisfies the recognition criteria in IAS 39 reflect circumstances at that date (IAS 39, paragraph 23). If the entity cannot determine the initial carrying amounts of the mbedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading (IAS 39, paragraph 26). This results in fair value measurement (except when the entity cannot determine a reliable fair value, see IAS 39, paragraph 70), with changes in fair value recognised in the income statement.~~ When 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 IAS 39 reflect circumstances at that date (IAS 39, paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, 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.

[4] ~~At the time of issue of this IFRS, a proposed SSAP based on the IASB's proposed revision to IAS 39 has been issued as an exposure draft. In accordance with paragraph 23 of SSAP 1, management should consider IAS 39 when accounting for a financial instrument other than a security that falls with the scope of SSAP 24 Accounting for Investments in Securities. Notwithstanding this, until the proposed SSAP based on IAS 39 becomes effective, IG51 to IG60 are only relevant to those first-time adopters that elect to follow IAS 39 in accounting for a financial instrument other than a security that falls within the scope of SSAP 24.~~

Measurement

~~IG56 In preparing its opening IFRS balance sheet, an entity applies the criteria in 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 90, 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 intent 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 83.~~

~~(b) to comply with IAS 39, paragraph 10, the category of 'loans and receivables originated by the enterprise' refers to the circumstances at origination.~~

~~(c) under IAS 39, paragraph 10, derivative financial assets and derivative financial liabilities are always deemed held for trading. The result is that an entity measures all derivative financial assets and derivative financial liabilities at fair value.~~

~~(d) to comply with IAS 39, paragraph 107, an entity classifies a non-derivative financial asset or non-derivative financial liability in its opening IFRS balance sheet as held for trading if, and only if, the asset or liability was:~~

~~(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or~~

~~(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.~~

~~(e) to comply with IAS 39, paragraph 10, available-for-sale financial assets are a residual category of financial assets that do not fall into any of the previous categories.~~

IG56 In preparing its opening IFRS balance sheet, an entity applies the criteria in 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) under 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 ~~at fair value~~.

(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 balance sheet as at fair value through profit or loss if, and 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 balance sheet, an entity determines their cost on the basis of circumstances existing when the assets and liabilities first satisfied the recognition criteria in IAS 39. However, if the entity acquired those financial assets and financial liabilities in a past business combination, their carrying amount under previous GAAP immediately following the business combination is their deemed cost under IFRSs at that date (paragraph B2(e) of the IFRS).

IG58 An entity's estimates of loan impairments at the date of transition to IFRSs are consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 31 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 at the date of transition to IFRSs only to the extent that it results from adopting IAS 39. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are classified as held for trading, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives shall be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which IAS 39 is initially applied (other than for a derivative that is a financial guarantee contracts or a designated and effective hedging instrument).

IG58B IAS 8 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 under IAS 8, with appropriate disclosures (IAS 8, paragraphs 32-40).

IG59 An entity may, under its previous GAAP, have measured investments at fair value and recognised the revaluation gain directly in equity. If an investment is classified as at fair value through profit or loss, the pre-IAS 39 revaluation gain that had been recognised in equity is reclassified into retained earnings on initial application of IAS 39. If, on initial application of IAS 39, an investment is classified as available for sale, then the pre-IAS 39 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on the available-for-sale financial asset 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 transfers to profit or loss the cumulative gain or loss remaining in equity (IAS 39, paragraph 55(b)).

Hedge accounting

IG60 Paragraphs 28-30 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, under 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 under 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, under previous GAAP, was either (i) not recognised or (ii) deferred in the balance sheet as an asset or liability.

IG60B An entity may, under 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 equity. Any net cumulative gain or loss that has been reclassified to equity on initial application of IAS 39 remains 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 that had been recognised directly in equity is recognised in profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge under IAS 39, hedge accounting is no longer appropriate starting from the date of transition to IFRSs.

~~SSAP 13~~ IAS 40 *~~Accounting for~~ Investment Propert~~ies~~y*

IG61 An entity that adopts the fair value model in ~~SSAP 13~~ IAS 40 measures its investment property at fair value at the date of transition to IFRSs.

IG62 An entity that applies ~~the exemption from open market value~~ the cost model in ~~SSAP 13~~IAS 40 applies paragraphs IG7-IG13 on property, plant and equipment.

Explanation of transition to IFRSs

IG63 Paragraphs 39(a) and (b), 40 and 41 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 balance sheet, income statement and, if applicable, cash flow statement. Paragraph 39(a) and (b) requires specific reconciliations of equity and profit or loss. IG Example 11 shows one way of satisfying these requirements.

IG Example 11: Reconciliation of equity and profit or loss

BACKGROUND

An entity first adopted IFRSs in 2005, with a date of transition to IFRSs of 1 January 2004. Its last financial statements under previous GAAP were for the year ended 31 December 2004.

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 2004). The IFRS also requires a reconciliation at the end of the last period presented under 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 under previous GAAP, the reconciliations distinguish the correction of those errors from changes in accounting policies (paragraph 41 of the IFRS). This example does not illustrate disclosure of a correction of an error.

RECONCILIATION OF EQUITY AT 1 JANUARY 2004 (DATE OF TRANSITION TO IFRSs)

Note		*Previous GAAP*	*Effect of transition to IFRSs*	*IFRSs*
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
	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 reserve	0	294	294
5	Hedging reserve	0	302	302
9	Retained earnings	5,060	479	5,539
	Total equity	6,560	1,075	7,635

NOTES TO THE RECONCILIATION OF EQUITY AT 1 JANUARY 2004:

1 Depreciation was influenced by tax requirements under previous GAAP, but under IFRSs reflects the useful life of the assets. The cumulative adjustment increased the carrying amount of property, plant and equipment by 100.

2 Intangible assets under previous GAAP included 150 for items that are transferred to goodwill because they do not qualify for recognition as intangible assets under IFRSs.

3 Financial assets are all classified as available-for-sale under IFRSs and are carried at their fair value of 3,891. They were carried at cost of 3,471 under previous GAAP. The resulting gains of 294 (420, less related deferred tax of 126) are included in the revaluation reserve.

4 Inventories include fixed and variable production overhead of 400 under IFRSs, but this overhead was excluded under previous GAAP.

5 Unrealised gains of 431 on unmatured forward foreign exchange contracts are recognised under IFRSs, but were not recognised under previous GAAP. The resulting gains of 302 (431, less related deferred tax of 129) are included in the hedging reserve because the contracts hedge forecast sales.

6 A pension liability of 66 is recognised under IFRSs, but was not recognised under previous GAAP, which used a cash basis.

7 A restructuring provision of 250 relating to head office activities was recognised under previous GAAP, but does not qualify for recognition as a liability under IFRSs.

8 The above changes increased the deferred tax liability as follows:

Revaluation reserve (note 3)	126
Hedging reserve (note 5)	129
Retained earnings	205
Increase in deferred tax liability	460

Because the tax base at 1 January 2004 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:

Depreciation (note 1)	100
Production overhead (note 4)	400
Pension liability (note 6)	(66)
Restructuring provision (note 7)	250
Tax effect of the above	(205)
Total adjustment to retained earnings	479

RECONCILIATION OF PROFIT OR LOSS FOR 2004

Note		*Previous GAAP*	*Effect of transition to IFRSs*	*IFRSs*
	Revenue	20,910	0	20,910
1,2,3	Cost of sales	(15,283)	(97)	(15,380)
	Gross profit	5,627	(97)	5,530
1	Distribution costs	(1,907)	(30)	(1,937)
2	Intangible assets	208	(150)	58
1,4	Administrative expenses	(2,842)	(300)	(3,142)
	Finance income	1,446	0	1,446
	Finance costs	(1,902)	0	(1,902)
	Profit before tax	422	(427)	(5)
5	Tax expense	(158)	128	(30)
	Net profit (loss)	264	(299)	(35)

NOTES TO THE RECONCILIATION OF PROFIT OR LOSS FOR 2004:

1. A pension liability is recognised under IFRSs, but was not recognised under previous GAAP. The pension liability increased by 130 during 2004, which caused increases in cost of sales (50), distribution costs (30) and administrative expenses (50).

2 Cost of sales is higher by 47 under IFRSs because inventories include fixed and variable production overhead under IFRSs but not under previous GAAP.

3 Depreciation was influenced by tax requirements under previous GAAP, but reflects the useful life of the assets under IFRSs. The effect on the profit for 2004 was not material.

4 A restructuring provision of 250 was recognised under previous GAAP at 1 January 2004, but did not qualify for recognition under IFRS until the year ended 31 December 2004. This increases administrative expenses for 2004 under IFRSs.

5 Adjustments 1-4 above lead to a reduction of 128 in deferred tax expense.

EXPLANATION OF MATERIAL ADJUSTMENTS TO THE CASH FLOW STATEMENT FOR 2004:

Income taxes of 133 paid during 2004 are classified as operating cash flows under IFRSs, but were included in a separate category of tax cash flows under previous GAAP. There are no other material differences between the cash flow statement presented under IFRSs and the cash flow statement presented under 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.

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 balance sheet date, 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 25E 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 have a reporting date of 31 December 2005 and include comparative information for 2004 only. Its date of transition to IFRSs is therefore 1 January 2004.

The entity acquired an energy plant on 1 January 2001, 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 2001.

APPLICATION OF REQUIREMENTS

The decommissioning liability recognised at the transition date is 77 (470 discounted for 37 years at 5 per cent).

Discounting this liability back for a further three years to 1 January 2001 gives an estimated liability at acquisition, to be included in the cost of the asset, of 67. Accumulated depreciation on the asset is 67 x 3/40 = 5.

The amounts recognised in the opening IFRS balance sheet on the date of transition to IFRSs (1 January 2004) are, in summary:

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 Paragraphs 25F of IFRS 1 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 have a reporting date of 31 December 2007 and include comparative information for 2006 only. Its date of transition to IFRSs is therefore 1 January 2006.

On 1 January 1995, the entity entered into a take-or-pay arrangement to supply gas. On 1 January 2000, there was a change in the contractual terms of the arrangement.

APPLICATION OF REQUIREMENTS

On 1 January 2006, 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 1995 and reassesses the arrangement on 1 January 2000. If the arrangement is determined to contain a lease, the entity follows the guidance in paragraphs IG14-IG16.

Appendix

Amendments resulting from other Implementation Guidance

The following sets out amendments required for this Guidance resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKAS 23 *Borrowing Costs* (issued in June 2007) – effective for annual periods beginning on or after 1 January 2009

Paragraphs IG23 and IG24 are amended as follows. Paragraph IG25 is deleted.

IG23 On first adopting IFRSs, an entity ~~adopts a policy of~~ begins capitalising borrowing costs (IAS 23 as revised in 2007) ~~allowed alternative treatment) or not capitalising them (IAS 23 benchmark treatment). The entity applies that policy consistently in its opening IFRS balance sheet and in all periods presented in its first IFRS financial statements~~. In accordance with paragraph 25I 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 ~~Under the allowed alternative treatment,~~ 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] ~~IAS 23 contains transitional provisions that encourage retrospective application, but permit an entity that adopts the allowed alternative treatment to capitalise (prospectively) only those borrowing costs incurred after the effective date of IAS 23 that meet the criteria for capitalisation. However, if a first-time adopter adopts the IAS 23 allowed alternative treatment, the IFRS requires retrospective application of that treatment, even for periods before the effective date of IAS 23 (paragraph 9 of the IFRS)~~.

HKAS 1 *Presentation of Financial Statements* (issued in December 2007) – effective for annual periods beginning on or after 1 January 2009

The Guidance on Implementing IFRS 1 is amended as described below.

In IG Examples 1–4, 201 and 202, 'Entity [X]'s [An entity's] first IFRS financial statements have a reporting date of' is amended to 'Entity [X]'s [An entity's] first IFRS financial statements are for a period that ends on'.

In IG Examples 1–4, 6–11 and 201, references to the years '2001' to '2007' are amended to '20X1' to '20X7' respectively.

In the heading above paragraph IG2 and in IG Example 1 (Assumption 2), 'IAS 10 *Events after the Balance Sheet Date*' is amended to 'IAS 10 *Events after the Reporting Period*'.

In paragraph IG2(b), 'balance sheet' is deleted.

In paragraph IG21, 'the reporting date' is amended to 'the end of the first IFRS reporting period'.

In paragraph IG31, 'post-balance sheet events review' is amended to 'review of events after the reporting period'.

In paragraph IG36, 'reporting date for its first IFRS financial statements' is amended to 'end of its first IFRS reporting period'.

IG Example 10 is amended as follows:

IG Example 10 Interim financial reporting

Background

Entity R's first IFRS financial statements ~~have~~ are for a ~~reporting date of~~ period that ends on 31 December 20X5 ~~2005~~, and its first interim financial report under IAS 34 is for the quarter ended 31 March 20X5 ~~2005~~. Entity R prepared previous GAAP annual financial statements for the year ended 31 December 20X4 ~~2004~~, and prepared quarterly reports throughout 20X4 ~~2004~~.

Application of requirements

In each quarterly interim financial report for 20X5 ~~2005~~, entity R includes reconciliations of:

(a) its equity under previous GAAP at the end of the comparable quarter of 20X4 ~~2004~~ to its equity under IFRSs at that date; and

(b) its total comprehensive income (or, if it did not report such a total, profit or loss) under previous GAAP for the comparable quarter of 20X4 ~~2004~~ (current and year-to-date) to its total comprehensive income ~~profit or loss~~ under 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 ~~2005~~ includes reconciliations of (or a cross reference to another published document that includes these reconciliations):

(a) its equity under previous GAAP at 1 January 20X4 ~~2004~~ and 31 December 20X4 ~~2004~~ to its equity under IFRSs at those dates; and

(b) its total comprehensive income (or, if it did not report such a total, profit or loss) for 20X4 ~~2004~~ under previous GAAP to its ~~profit or loss~~ total comprehensive income for 20X4 ~~2004~~ under IFRSs. …

In paragraph IG43, ‘the income statement’ is amended to ‘profit or loss’.

Paragraphs IG52, IG59 and IG60B are amended as follows:

IG52 An entity recognises and measures all financial assets and financial liabilities in its opening IFRS ~~balance sheet~~ statement of financial position in accordance with IAS 39, except as specified in paragraphs 27−30 of the IFRS, which address derecognition and hedge accounting~~, and paragraph 36A, which permits an exemption from restating comparative information.~~

IG59 An entity may, under its previous GAAP, have measured investments at fair value and recognised the revaluation gain ~~directly in equity~~ outside profit or loss. If an investment is classified as at fair value through profit or loss, the pre-IAS 39 revaluation gain that had been recognised ~~in equity~~ outside profit or loss is reclassified into retained earnings on initial application of IAS 39. If, on initial application of IAS 39, an investment is classified as available for sale, then the pre-IAS 39 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on 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 ~~transfers~~ reclassifies to profit or loss the cumulative gain or loss remaining in equity (IAS 39, paragraph 55(b)).

IG60B An entity … Any net cumulative gain or loss that has been reclassified to equity on initial application of IAS 39 remains 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 ~~that had been recognised directly in equity is recognised in~~ is reclassified from equity to profit or loss. If …

Paragraph IG63 and IG Example 11 are amended as follows:

IG63 Paragraphs 39(a) and (b), 40 and 41 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 ~~balance sheet, income~~ statement of financial position, statement of comprehensive income and, if applicable, ~~cash flow~~ statement of cash flows. Paragraph 39(a) and (b) requires specific reconciliations of equity and ~~profit or loss~~ total comprehensive income. IG Example 11 shows one way of satisfying these requirements.

IG Example 11 Reconciliation of equity and ~~profit or loss~~ total comprehensive income

...

Reconciliation of ~~profit or loss~~ total comprehensive income for ~~2004~~20X4

Note		*Previous GAAP*	*Effect of transition to IFRSs*	*IFRSs*
	Revenue	20,910	0	20,910
1,2,3	Cost of sales	(15,283)	(97)	(15,380)
	Gross profit	5,627	(97)	5,530
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	(1,902)	0	(1,902)
	Profit before tax	422	(427)	(5)
5	Tax expense	(158)	128	(30)
	Profit (loss) for the year	264	(299)	(35)
6	Available-for-sale financial assets	0	150	150
7	Cash flow hedges	0	(40)	(40)
8	Tax relating to other comprehensive income	0	(29)	(29)
	Other comprehensive income	0	81	81
	Total comprehensive income	264	(218)	46

Notes to the reconciliation of ~~profit or loss~~ total comprehensive income for ~~2004~~ 20X4:

...

6 Available-for-sale financial assets carried at fair value under IFRSs increased in value by 180 during 20X4. They were carried at cost under previous GAAP. The entity sold available-for-sale financial assets during the year, recognising a gain of 40 in profit or loss. Of that realised gain 30 had been included in the revaluation reserve as at 1 January 20X4 and is reclassified from revaluation reserve 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 40 during 20X4.

8 Adjustments 6 and 7 above lead to an increase of 29 in deferred tax expense.

In IG Example 202, references to ‘1995’ are amended to ‘20X5’ and references to the years ‘2000’ to ‘2007’ are amended to ‘20Y0’ to ‘20Y7’ respectively.

HKAS 27 *Consolidated and Separate Financial Statements* (issued in March 2008) - effective for annual periods beginning on or after 1 July 2009

References to ‘minority interests’ are amended to ‘non-controlling interests’ in paragraphs IG Example 4, IG Example 5, IG Example 6 and IG 28.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In the guidance on implementing IFRS 1 (both June 2003 and November 2008 versions), the heading above paragraph IG52 and paragraphs IG52-IG55, IG56, IG58, IG58A and IG59 are amended as follows:

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*

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 and IAS 39 respectively, except as specified in paragraphs B2–B6 of the IFRS, which address derecognition and hedge accounting.

IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with IAS 39 and IFRS 9 and have not yet qualified for derecognition in accordance with IAS 39, except non-derivative financial assets and non-derivative financial liabilities derecognised in accordance with previous GAAP before 1 January 2004, 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 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, those further transfers qualify for derecognition only if they meet the derecognition criteria of IAS 39.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition in accordance with IAS 39 or IFRS 9, or have already qualified for derecognition in accordance with IAS 39.

IG55 When IAS 39 requires an entity to separate an embedded derivative from a host contract outside the scope of IFRS 9, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IAS 39 reflect circumstances at that date (IAS 39 paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it ~~treats~~ designates the entire combined contract as ~~a financial instrument held for trading~~ at fair value through profit or loss (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.~~

IG56 In preparing its opening IFRS statement of financial position, an entity applies the criteria in IAS 39 and IFRS 9 to identify on the basis of the facts and circumstances that exist at the date of transition to IFRSs those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost. The resulting classifications are applied retrospectively. ~~In particular:~~

~~(a) to comply with ...~~

...

~~(e) ... any of the previous categories.~~

IG58 An entity's estimates of ~~loan~~ impairments of financial assets measured at amortised cost at the date of transition to IFRSs are consistent with estimates made for the same date …

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 at the date of transition to IFRSs only to the extent that it results from adopting IAS 39 and IFRS 9. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are ~~classified as held for trading~~ measured at fair value through profit or loss, 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 and IFRS 9 are ~~is~~ initially applied (other than for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

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-~~IAS 39~~ 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 in an equity instrument is classified as ~~available for sale~~ at fair value through other comprehensive income, then the pre-~~IAS 39~~ IFRS 9 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on the ~~available-for-sale~~ financial asset in other comprehensive income (except dividends, which are recognised in profit or loss) 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)).~~ may transfer that separate component of equity within equity.

IG Example 11 in paragraph IG63 is amended as follows:

The table 'Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)' is amended to read as follows:

Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)

Note		*Previous GAAP*	*Effect of transition to IFRSs*	*IFRSs*
		CU	CU	CU
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

continued…

continued…

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
	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
5	Hedging reserve	0	302	302
9	Retained earnings	5,060	773	5,833
	Total equity	6,560	1,075	7,635

Note 3 to the reconciliation of equity at 1 January 20X4 is amended as follows:

3	Financial assets are all classified as ~~available for sale~~ at fair value through profit or loss 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 revaluation surplus~~ retained earnings.

Note 8 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

8 The above changes increased the deferred tax liability as follows:

	CU
Hedging reserve (note 5)	129
Retained earnings	331
Increase in deferred tax liability	460

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.

Note 9 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

9 The adjustments to retained earnings are as follows:

	CU
Depreciation (note 1)	100
Financial assets (note 3)	420
Production overhead (note 4)	400
Pension liability (note 6)	(66)
Restructuring provision (note 7)	250
Tax effect of the above	(331)
Total adjustment to retained earnings	773

The reconciliation of total comprehensive income for 20X4 is amended to read as follows:

Reconciliation of total comprehensive income for 20X4

Note		*Previous GAAP*	*Effect of transition to IFRSs*	*IFRSs*
		CU	CU	CU
	Revenue	20,910	0	20,910
1, 2, 3	Cost of sales	(15,283)	(97)	(15,380)
	Gross profit	5,627	(97)	5,530
6	Other income	0	180	180
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	(1,902)	0	(1,902)
	Profit before tax	422	(247)	175
5	Tax expense	(158)	74	(84)
	Profit (loss) for the year	264	(173)	91
7	Cash flow hedges	0	(40)	(40)
8	Tax relating to other comprehensive income	0	(29)	(29)
	Other comprehensive income	0	(69)	(69)
	Total comprehensive income	264	(242)	22

Note 6 to the reconciliation of total comprehensive income for 20X4 is amended as follows:

6 ~~Available-for-sale f~~ Financial assets at fair value through profit or loss ~~carried at fair value 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).~~

HKFRS 2
Revised ~~July 2009~~February 2010

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by International Accounting Standards Committee Foundation. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

Contents

paragraphs

INTRODUCTION **IN1-IN8**

Hong Kong Financial Reporting Standard 2
SHARE-BASED PAYMENT

OBJECTIVE **1**

SCOPE **2-6**

RECOGNITION **7-9**

EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS **10-29**

Overview **10-13A**

Transactions in which services are received **14-15**

Transactions measured by reference to the fair value of the equity instruments granted **16-25**

Determining the fair value of equity instruments granted 16-18
Treatment of vesting conditions 19-21
Treatment of non-vesting conditions 21A
Treatment of a reload feature 22
After vesting date 23
If the fair value of the equity instruments cannot be estimated reliably 24-25

Modifications to the terms and conditions on which equity instruments were granted, including cancellations and settlements **26-29**

CASH-SETTLED SHARE-BASED PAYMENT TRANSACTIONS **30-33**

SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES **34-43**

© Copyright

Share-based payment transactions in which the terms of the arrangement provide the counterparty with a choice of settlement **35-40**

Share-based payment transactions in which the terms of the arrangement provide the entity with a choice of settlement **41-43**

SHARE-BASED PAYMENT TRANSACTIONS AMONG GROUP ENTITIES **43A-43D**

DISCLOSURES **44-52**

TRANSITIONAL PROVISIONS **53-59**

EFFECTIVE DATE **60-6~~2~~3**

WITHDRAWAL OF INTERPRETATIONS **64**

APPENDICES

A **Defined terms**

B **Application guidance**

C **Amendments to other HKFRSs**

~~**D** **Amendments to HKFRS 2** ***Group Cash-settled Share-based Payment Transactions***~~

~~E~~D **Comparison with International Financial Reporting Standards**

BASIS FOR CONCLUSIONS

IMPLEMENTATION GUIDANCE

Hong Kong Financial Reporting Standard 2 *Share-based Payment* (HKFRS 2) is set out in paragraphs 1-6~~2~~4 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 *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.

INTRODUCTION

Reasons for issuing the HKFRS

IN1 Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

IN2 Until this HKFRS was issued, there was no HKFRS covering the recognition and measurement of these transactions. Concerns were raised about this gap in HKFRSs, given the increasing prevalence of share-based payment transactions in many countries.

Reasons for amending HKFRS 2 in July 2009

IN2A* In July 2009 the Hong Kong Institute of Certified Public Accountants (HKICPA) amended HKFRS 2 to clarify its scope and the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment transaction. The amendments also incorporate the guidance contained in the following Interpretations:

- HK(IFRIC)-Int 8 *Scope of HKFRS 2*
- HK(IFRIC)-Int 11 *HKFRS 2—Group and Treasury Share Transactions.*

As a result, HKICPA withdrew HK(IFRIC)-Int 8 and HK(IFRIC)-Int 11.

Main features of the HKFRS

IN3 The HKFRS requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. There are no exceptions to the HKFRS, other than for transactions to which other Standards apply.

IN4 The HKFRS sets out measurement principles and specific requirements for three types of share-based payment transactions:

(a) equity-settled share-based payment transactions, in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options);

(b) cash-settled share-based payment transactions, in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity; and

(c) transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments.

* Amendments effective for annual periods beginning on or after 1 January 2010.

IN5 For equity-settled share-based payment transactions, the HKFRS requires an entity to measure 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, the entity is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. Furthermore:

(a) for transactions with employees and others providing similar services, the entity is required to measure the fair value of the equity instruments granted, because it is typically not possible to estimate reliably the fair value of employee services received. The fair value of the equity instruments granted is measured at grant date.

(b) for transactions with parties other than employees (and those providing similar services), there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. That fair value is measured at the date the entity obtains the goods or the counterparty renders service. In rare cases, if the presumption is rebutted, the transaction is measured 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.

(c) for goods or services measured by reference to the fair value of the equity instruments granted, the HKFRS specifies that all non-vesting conditions are taken into account in the estimate of the fair value of the equity instruments. However, vesting conditions~~,~~ that are not market conditions~~,~~ are not taken into account when estimating the fair value of the shares or options at the relevant measurement date (as specified above). Instead, vesting conditions are 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 is 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).

(d) the HKFRS requires the fair value of equity instruments granted to be based on market prices, if available, and to take into account the terms and conditions upon which those equity instruments were granted. In the absence of market prices, fair value is estimated, 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.

(e) the HKFRS also sets out requirements if the terms and conditions of an option or share grant are modified (e.g. an option is repriced) or if a grant is cancelled, repurchased or replaced with another grant of equity instruments. For example, irrespective of any modification, cancellation or settlement of a grant of equity instruments to employees, the HKFRS generally requires the entity to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted.

© Copyright

IN6 For cash-settled share-based payment transactions, the HKFRS requires an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity is required to remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in value recognised in profit or loss for the period.

IN7 For share-based payment transactions in which the terms of the arrangement provide either the entity or the supplier of goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments, the entity is required to 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.

IN8 The HKFRS prescribes various disclosure requirements to enable users of financial statements to understand:

(a) the nature and extent of share-based payment arrangements that existed during the period;

(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and

(c) the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

Hong Kong Financial Reporting Standard 2
Share-based Payment

Objective

1 The objective of this HKFRS is to specify the financial reporting by an entity when it undertakes a *share-based payment transaction*. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which *share options* are granted to employees.

Scope

2[*] An entity shall apply this HKFRS in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including:

(a) *equity-settled share-based payment transactions*,~~ in which the entity receives goods or services as consideration for *equity instruments* of the entity (including shares or share options), ~~

(b) *cash-settled share-based payment transactions*, ~~in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity, ~~and

(c) transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments,

except as noted in paragraphs~~ 5 and 6~~3A-6. In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case this HKFRS applies.

3[*] [Deleted]~~For the purposes of this HKFRS, transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity (including employees) are share-based payment transactions, unless the transfer is clearly for a purpose other than payment for goods or services supplied to the entity. This also applies to transfers of equity instruments of the entity's parent, or equity instruments of another entity in the same group as the entity, to parties that have supplied goods or services to the entity.~~

3A[*] A share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services. Paragraph 2 also applies to an entity that

(a) receives goods or services when another entity in the same group (or a shareholder of any group entity) has the obligation to settle the share-based payment transaction, or

[*] Amendments effective for annual periods beginning on or after 1 January 2010.

(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 HKAS 31 *Interests in Joint Ventures*. 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 of HKAS 39 *Financial Instruments: Recognition and Measurement*.

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.

[♦] Amendments effective for annual periods beginning on or after 1 July 2009.

[*] The title of HKAS 32 was amended in 2005.

8 When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses.

9 Typically, an expense arises from the consumption of goods or services. For example, services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service. Goods might be consumed over a period of time or, in the case of inventories, sold at a later date, in which case an expense is recognised when the goods are consumed or sold. However, sometimes it is necessary to recognise an expense before the goods or services are consumed or sold, because they do not qualify for recognition as assets. For example, an entity might acquire goods as part of the research phase of a project to develop a new product. Although those goods have not been consumed, they might not qualify for recognition as assets under the applicable HKFRS.

Equity-settled share-based payment transactions

Overview

10 For equity-settled share-based payment transactions, the entity shall measure 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, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to[*] the fair value of the *equity instruments granted*.

11 To apply the requirements of paragraph 10 to transactions with *employees and others providing similar services*,[†] the entity shall measure the fair value of the services received by reference to the fair value of the equity instruments granted, because typically it is not possible to estimate reliably the fair value of the services received, as explained in paragraph 12. The fair value of those equity instruments shall be measured at *grant date*.

12 Typically, shares, share options or other equity instruments are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the equity instruments granted. Furthermore, shares or share options are sometimes granted as part of a bonus arrangement, rather than as a part of basic remuneration, e.g. as an incentive to the employees to remain in the entity's employ or to reward them for their efforts in improving the entity's performance. By granting shares or share options, in addition to other remuneration, the entity is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of the services received, the entity shall measure the fair value of the employee services received by reference to the fair value of the equity instruments granted.

---

[*] This HKFRS uses the phrase 'by reference to' rather than 'at', because the transaction is ultimately measured by multiplying the fair value of the equity instruments granted, measured at the date specified in paragraph 11 or 13 (whichever is applicable), by the number of equity instruments that vest, as explained in paragraph 19.

[†] In the remainder of this HKFRS, all references to employees also includes others providing similar services.

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

* Amendments effective for annual periods beginning on or after 1 January 2010.

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 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, 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.**

© Copyright

20 To apply the requirements of paragraph 19, the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements of paragraph 21.

21 Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognise the goods or services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.

Treatment of non-vesting conditions

21A Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.

Treatment of a reload feature

22 For options with a *reload feature*, the reload feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a *reload option* shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

After vesting date

23 Having recognised the goods or services received in accordance with paragraphs 10–22, and a corresponding increase in equity, the entity shall make no subsequent adjustment to total equity after vesting date. For example, the entity shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised. However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

If the fair value of the equity instruments cannot be estimated reliably

24 The requirements in paragraphs 16–23 apply when the entity is required to measure a share-based payment transaction by reference to the fair value of the equity instruments granted. In rare cases, the entity may be unable to estimate reliably the fair value of the equity instruments granted at the measurement date, in accordance with the requirements in paragraphs 16–22. In these rare cases only, the entity shall instead:

© Copyright

(a) measure the equity instruments at their *intrinsic value*, initially at the date the entity obtains the goods or the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, are forfeited (e.g. upon cessation of employment) or lapse (e.g. at the end of the option's life).

(b) recognise the goods or services received based on the number of equity instruments that ultimately vest or (where applicable) are ultimately exercised. To apply this requirement to share options, for example, the entity shall recognise the goods or services received during the vesting period, if any, in accordance with paragraphs 14 and 15, except that the requirements in paragraph 15(b) concerning a market condition do not apply. The amount recognised for goods or services received during the vesting period shall be based on the number of share options expected to vest. The entity shall revise that estimate, if necessary, if subsequent information indicates that the number of share options expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested. After vesting date, the entity shall reverse the amount recognised for goods or services received if the share options are later forfeited, or lapse at the end of the share option's life.

25 If an entity applies paragraph 24, it is not necessary to apply paragraphs 26-29, because any modifications to the terms and conditions on which the equity instruments were granted will be taken into account when applying the intrinsic value method set out in paragraph 24. However, if an entity settles a grant of equity instruments to which paragraph 24 has been applied:

(a) if the settlement occurs during the vesting period, the entity shall account for the settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period.

(b) any payment made on settlement shall be accounted for as the repurchase of equity instruments, i.e. as a deduction from equity, except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. Any such excess shall be recognised as an expense.

Modifications to the terms and conditions on which equity instruments were granted, including cancellations and settlements

26 An entity might modify the terms and conditions on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options. The requirements in paragraphs 27–29 to account for the effects of modifications are expressed in the context of share-based payment transactions with employees. However, the requirements shall also be applied to share-based payment transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted. In the latter case, any references in paragraphs 27–29 to grant date shall instead refer to the date the entity obtains the goods or the counterparty renders service.

© Copyright

27 The entity shall recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments. In addition, the entity shall recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. Guidance on applying this requirement is given in Appendix B.

28 If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

(c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 and the guidance in Appendix B. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.

28A If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.

29 If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

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. 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 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. upon cessation of employment) or at the employee's option.

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.

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.

© Copyright

Share-based payment transactions in which the terms of the arrangement provide the counterparty with a choice of settlement

35 If an entity has granted the counterparty the right to choose whether a share-based payment transaction is settled in cash[*] or by issuing equity instruments, the entity has granted a compound financial instrument, which includes a debt component (i.e. the counterparty's right to demand payment in cash) and an equity component (i.e. the counterparty's right to demand settlement in equity instruments rather than in cash). For transactions with parties other than employees, in which the fair value of the goods or services received is measured directly, the entity shall measure the equity component of the compound financial instrument as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

36 For other transactions, including transactions with employees, the entity shall measure the fair value of the compound financial instrument at the measurement date, taking into account the terms and conditions on which the rights to cash or equity instruments were granted.

37 To apply paragraph 36, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component—taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the compound financial instrument is the sum of the fair values of the two components. However, share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually 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.

38 The entity shall account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. For the debt component, the entity shall recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in accordance with the requirements applying to cash-settled share-based payment transactions (paragraphs 30–33). For the equity component (if any), the entity shall recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in accordance with the requirements applying to equity-settled share-based payment transactions (paragraphs 10–29).

39 At the date of settlement, the entity shall remeasure the liability to its fair value. If the entity issues equity instruments on settlement rather than paying cash, the liability shall be transferred direct to equity, as the consideration for the equity instruments issued.

[*] In paragraphs 35–43, all references to cash also include other assets of the entity.

40 If the entity pays in cash on settlement rather than issuing equity instruments, that payment shall be applied to settle the liability in full. Any equity component previously recognised shall remain within equity. By electing to receive cash on settlement, the counterparty forfeited the right to receive equity instruments. However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Share-based payment transactions in which the terms of the arrangement provide the entity with a choice of settlement

41 For a share-based payment transaction in which the terms of the arrangement provide an entity with the choice of whether to settle in cash or by issuing equity instruments, the entity shall determine whether it has a present obligation to settle in cash and account for the share-based payment transaction accordingly. The entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the entity is legally prohibited from issuing shares), or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

42 If the entity has a present obligation to settle in cash, it shall account for the transaction in accordance with the requirements applying to cash-settled share-based payment transactions, in paragraphs 30–33.

43 If no such obligation exists, the entity shall account for the transaction in accordance with the requirements applying to equity-settled share-based payment transactions, in paragraphs 10–29. Upon settlement:

(a) if the entity elects to settle in cash, the cash payment shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except as noted in (c) below.

(b) if the entity elects to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary), except as noted in (c) below.

(c) if the entity elects the settlement alternative with the higher fair value, as at the date of settlement, the entity shall recognise an additional expense for the excess value given, i.e. the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Share-based payment transactions among group entities (2009 amendments)[*]

43A For share-based payment transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services shall measure the goods or services received as either an equity-settled or a cash-settled share-based payment transaction by assessing:

(a) the nature of the awards granted, and

[*] Amendments effective for annual periods beginning on or after 1 January 2010.

(b) its own rights and obligations.

The amount recognised by the entity receiving the goods or services may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction.

43B The entity receiving the goods or services shall measure the goods or services received as an equity-settled share-based payment transaction when:

(a) the awards granted are its own equity instruments, or

(b) the entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently remeasure such an equity-settled share-based payment transaction only for changes in non-market vesting conditions in accordance with paragraphs 19–21. In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

43C The entity settling a share-based payment transaction when another entity in the group receives the goods or services shall recognise the transaction as an equity-settled share-based payment transaction only if it is settled in the entity's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.

43D Some group transactions involve repayment arrangements that require one group entity to pay another group entity for the provision of the share-based payments to the suppliers of goods or services. In such cases, the entity that receives the goods or services shall account for the share-based payment transaction in accordance with paragraph 43B regardless of intragroup repayment arrangements.

Disclosures

44 An entity shall disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

45 To give effect to the principle in paragraph 44, the entity shall disclose at least the following:

(a) a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g. whether in cash or equity). An entity with substantially similar types of share-based payment arrangements may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 44.

(b) the number and weighted average exercise prices of share options for each of the following groups of options:

(i) outstanding at the beginning of the period;

(ii) granted during the period;

© Copyright

(iii) forfeited during the period;

(iv) exercised during the period;

(v) expired during the period;

(vi) outstanding at the end of the period; and

(vii) exercisable at the end of the period.

(c) for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.

(d) for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

46 An entity shall disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.

47 If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, to give effect to the principle in paragraph 46, the entity shall disclose at least the following:

(a) for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including:

(i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

(ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and

(iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) for other equity instruments granted during the period (i.e. other than share options), the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured, including:

© Copyright

(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 does not satisfy the principles in paragraphs 44, 46 and 50, the entity shall disclose such additional information as is necessary to satisfy them.

© Copyright

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.

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;

[♦] Amendments effective for annual periods beginning on or after 1 July 2009.

(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 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.

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.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

cash-settled share-based payment transaction

A **share-based payment transaction** in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of ~~the entity's shares or other~~ **equity instruments** (including shares or **share options**) of the entity or another group entity.

employees and others providing similar services

Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, i.e. those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

equity instrument

A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.*

equity instrument granted

The right (conditional or unconditional) to an **equity instrument** of the entity conferred by the entity on another party, under a **share-based payment arrangement**.

equity-settled share-based payment transaction

A **share-based payment transaction** in which the entity

(a) receives goods or services as consideration for its own **equity instruments** ~~of the entity~~ (including shares or **share options**),

or

(b) receive goods or services but has no obligation to settle the transaction with the supplier.

fair value

The amount for which an asset could be exchanged, a liability settled, or an **equity instrument granted** could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

---

* The *Framework* defines a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (i.e. an outflow of cash or other assets of the entity).

grant date

The date at which the entity and another party (including an employee) agree to a **share-based payment arrangement**, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or **equity instruments** of the entity, provided the specified **vesting conditions**, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

intrinsic value

The difference between the **fair value** of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a **share option** with an exercise price of CU15,[*] on a share with a **fair value** of CU20, has an intrinsic value of CU5.

market condition

A condition upon which the exercise price, vesting or exercisability of an **equity instrument** depends that is related to the market price of the entity's **equity instruments**, such as attaining a specified share price or a specified amount of **intrinsic value** of a **share option**, or achieving a specified target that is based on the market price of the entity's **equity instruments** relative to an index of market prices of **equity instruments** of other entities.

measurement date

The date at which the **fair value** of the **equity instruments granted** is measured for the purposes of this HKFRS. For transactions with **employees and others providing similar services**, the measurement date is **grant date**. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

reload feature

A feature that provides for an automatic grant of additional **share options** whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.

reload option

A new **share option** granted when a share is used to satisfy the exercise price of a previous **share option**.

[*] In this appendix, monetary amounts are denominated in 'currency units' (CU).

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) ~~to enter into a~~ ~~**share-based payment transaction**~~ ~~which thereby~~ 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 ~~the entity's shares or other~~ **equity instruments** (including shares or **share options**) of the entity or another group entity, or ~~to receive~~

(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 ~~as consideration for~~ ~~**equity instruments**~~ ~~of the entity (including shares or~~ ~~**share options**~~~~), or acquires goods or services by incurring liabilities to~~ 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.~~for amounts that are based on the price of the entity's shares or other~~ ~~**equity instruments**~~ ~~of the entity.~~

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**.

[(a)] A 'group' is defined in paragraph 4 of HKAS 27 *Consolidated and Separate Financial Statements* as 'a parent and its subsidiaries' from the perspective of the reporting entity's ultimate parent.

vesting conditions	The conditions that determine 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** Vesting conditions are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a **market condition**.
vesting period	The period during which all the specified **vesting conditions** of a **share-based payment arrangement** are to be satisfied.

© Copyright

Appendix B
Application guidance

This appendix is an integral part of the HKFRS.

Estimating the fair value of equity instruments granted

B1 Paragraphs B2–B41 of this appendix discuss measurement of the fair value of shares and share options granted, focusing on the specific terms and conditions that are common features of a grant of shares or share options to employees. Therefore, it is not exhaustive. Furthermore, because the valuation issues discussed below focus on shares and share options granted to employees, it is assumed that the fair value of the shares or share options is measured at grant date. However, many of the valuation issues discussed below (e.g. determining expected volatility) also apply in the context of estimating the fair value of shares or share options granted to parties other than employees at the date the entity obtains the goods or the counterparty renders service.

Shares

B2 For shares granted to employees, the fair value of the shares shall be measured at the market price of the entity's shares (or an estimated market price, if the entity's shares are not publicly traded), adjusted to take into account the terms and conditions upon which the shares were granted (except for vesting conditions that are excluded from the measurement of fair value in accordance with paragraphs 19–21).

B3 For example, if the employee is not entitled to receive dividends during the vesting period, this factor shall be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. Restrictions on transfer or other restrictions that exist during the vesting period shall not be taken into account when estimating the grant date fair value of the shares granted, because those restrictions stem from the existence of vesting conditions, which are accounted for in accordance with paragraphs 19–21.

Share options

B4 For share options granted to employees, in many cases market prices are not available, because the options granted are subject to terms and conditions that do not apply to traded options. If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying an option pricing model.

B5 The entity shall consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. For example, many employee options have long lives, are usually exercisable during the period between vesting date and the end of the options' life, and are often exercised early. These factors should be considered when estimating the grant date fair value of the options. For many entities, this might preclude the use of the Black-Scholes-Merton formula, which does not allow for the possibility of exercise before the end of the option's life and may not adequately reflect the effects of expected early exercise. It also does not allow for the possibility that expected volatility and other model inputs might vary

over the option's life. However, for share options with relatively short contractual lives, or that must be exercised within a short period of time after vesting date, the factors identified above may not apply. In these instances, the Black-Scholes-Merton formula may produce a value that is substantially the same as a more flexible option pricing model.

B6 All option pricing models take into account, as a minimum, the following factors:

(a) the exercise price of the option;

(b) the life of the option;

(c) the current price of the underlying shares;

(d) the expected volatility of the share price;

(e) the dividends expected on the shares (if appropriate); and

(f) the risk-free interest rate for the life of the option.

B7 Other factors that knowledgeable, willing market participants would consider in setting the price shall also be taken into account (except for vesting conditions and reload features that are excluded from the measurement of fair value in accordance with paragraphs 19–22).

B8 For example, a share option granted to an employee typically cannot be exercised during specified periods (e.g. during the vesting period or during periods specified by securities regulators). This factor shall be taken into account if the option pricing model applied would otherwise assume that the option could be exercised at any time during its life. However, if an entity uses an option pricing model that values options that can be exercised only at the end of the options' life, no adjustment is required for the inability to exercise them during the vesting period (or other periods during the options' life), because the model assumes that the options cannot be exercised during those periods.

B9 Similarly, another factor common to employee share options is the possibility of early exercise of the option, for example, because the option is not freely transferable, or because the employee must exercise all vested options upon cessation of employment. The effects of expected early exercise shall be taken into account, as discussed in paragraphs B16-B21.

B10 Factors that a knowledgeable, willing market participant would not consider in setting the price of a share option (or other equity instrument) shall not be taken into account when estimating the fair value of share options (or other equity instruments) granted. For example, for share options granted to employees, factors that affect the value of the option from the individual employee's perspective only are not relevant to estimating the price that would be set by a knowledgeable, willing market participant.

© Copyright

Inputs to option pricing models

B11 In estimating the expected volatility of and dividends on the underlying shares, the objective is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee share options, the objective is to approximate the expectations that an outside party with access to detailed information about employees' exercise behaviour would develop based on information available at the grant date.

B12 Often, there is likely to be a range of reasonable expectations about future volatility, dividends and exercise behaviour. If so, an expected value should be calculated, by weighting each amount within the range by its associated probability of occurrence.

B13 Expectations about the future are generally based on experience, modified if the future is reasonably expected to differ from the past. In some circumstances, identifiable factors may indicate that unadjusted historical experience is a relatively poor predictor of future experience. For example, if an entity with two distinctly different lines of business disposes of the one that was significantly less risky than the other, historical volatility may not be the best information on which to base reasonable expectations for the future.

B14 In other circumstances, historical information may not be available. For example, a newly listed entity will have little, if any, historical data on the volatility of its share price. Unlisted and newly listed entities are discussed further below.

B15 In summary, an entity should not simply base estimates of volatility, exercise behaviour and dividends on historical information without considering the extent to which the past experience is expected to be reasonably predictive of future experience.

Expected early exercise

B16 Employees often exercise share options early, for a variety of reasons. For example, employee share options are typically non-transferable. This often causes employees to exercise their share options early, because that is the only way for the employees to liquidate their position. Also, employees who cease employment are usually required to exercise any vested options within a short period of time, otherwise the share options are forfeited. This factor also causes the early exercise of employee share options. Other factors causing early exercise are risk aversion and lack of wealth diversification.

B17 The means by which the effects of expected early exercise are taken into account depends upon the type of option pricing model applied. For example, expected early exercise could be taken into account by using an estimate of the option's expected life (which, for an employee share option, is the period of time from grant date to the date on which the option is expected to be exercised) as an input into an option pricing model (e.g. the Black-Scholes-Merton formula). Alternatively, expected early exercise could be modelled in a binomial or similar option pricing model that uses contractual life as an input.

© Copyright

B18 Factors to consider in estimating early exercise include:

(a) the length of the vesting period, because the share option typically cannot be exercised until the end of the vesting period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest. The implications of vesting conditions are discussed in paragraphs 19–21.

(b) the average length of time similar options have remained outstanding in the past.

(c) the price of the underlying shares. Experience may indicate that the employees tend to exercise options when the share price reaches a specified level above the exercise price.

(d) the employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (discussed further in paragraph B21).

(e) expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility.

B19 As noted in paragraph B17, the effects of early exercise could be taken into account by using an estimate of the option's expected life as an input into an option pricing model. When estimating the expected life of share options granted to a group of employees, the entity could base that estimate on an appropriately weighted average expected life for the entire employee group or on appropriately weighted average lives for subgroups of employees within the group, based on more detailed data about employees' exercise behaviour (discussed further below).

B20 Separating an option grant into groups for employees with relatively homogeneous exercise behaviour is likely to be important. Option value is not a linear function of option term; value increases at a decreasing rate as the term lengthens. For example, if all other assumptions are equal, although a two-year option is worth more than a one-year option, it is not worth twice as much. That means that calculating estimated option value on the basis of a single weighted average life that includes widely differing individual lives would overstate the total fair value of the share options granted. Separating options granted into several groups, each of which has a relatively narrow range of lives included in its weighted average life, reduces that overstatement.

B21 Similar considerations apply when using a binomial or similar model. For example, the experience of an entity that grants options broadly to all levels of employees might indicate that top-level executives tend to hold their options longer than middle-management employees hold theirs and that lower-level employees tend to exercise their options earlier than any other group. In addition, employees who are encouraged or required to hold a minimum amount of their employer's equity instruments, including options, might on average exercise options later than employees not subject to that provision. In those situations, separating options by groups of recipients with relatively homogeneous exercise behaviour will result in a more accurate estimate of the total fair value of the share options granted.

Expected volatility

B22 Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

B23 The rate of return (which may be positive or negative) on a share for a period measures how much a shareholder has benefited from dividends and appreciation (or depreciation) of the share price.

B24 The expected annualised volatility of a share is the range within which the continuously compounded annual rate of return is expected to fall approximately two-thirds of the time. For example, to say that a share with an expected continuously compounded rate of return of 12 per cent has a volatility of 30 per cent means that the probability that the rate of return on the share for one year will be between –18 per cent (12% – 30%) and 42 per cent (12% + 30%) is approximately two-thirds. If the share price is CU100 at the beginning of the year and no dividends are paid, the year-end share price would be expected to be between CU83.53 (CU100 × $e^{-0.18}$) and CU152.20 (CU100 × $e^{0.42}$) approximately two-thirds of the time.

B25 Factors to consider in estimating expected volatility include:

(a) implied volatility from traded share options on the entity's shares, or other traded instruments of the entity that include option features (such as convertible debt), if any.

(b) the historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise).

(c) the length of time an entity's shares have been publicly traded. A newly listed entity might have a high historical volatility, compared with similar entities that have been listed longer. Further guidance for newly listed entities is given below.

(d) the tendency of volatility to revert to its mean, i.e. its long-term average level, and other factors indicating that expected future volatility might differ from past volatility. For example, if an entity's share price was extraordinarily volatile for some identifiable period of time because of a failed takeover bid or a major restructuring, that period could be disregarded in computing historical average annual volatility.

(e) appropriate and regular intervals for price observations. The price observations should be consistent from period to period. For example, an entity might use the closing price for each week or the highest price for the week, but it should not use the closing price for some weeks and the highest price for other weeks. Also, the price observations should be expressed in the same currency as the exercise price.

© Copyright

Newly listed entities

B26 As noted in paragraph B25, an entity should consider historical volatility of the share price over the most recent period that is generally commensurate with the expected option term. If a newly listed entity does not have sufficient information on historical volatility, it should nevertheless compute historical volatility for the longest period for which trading activity is available. It could also consider the historical volatility of similar entities following a comparable period in their lives. For example, an entity that has been listed for only one year and grants options with an average expected life of five years might consider the pattern and level of historical volatility of entities in the same industry for the first six years in which the shares of those entities were publicly traded.

Unlisted entities

B27 An unlisted entity will not have historical information to consider when estimating expected volatility. Some factors to consider instead are set out below.

B28 In some cases, an unlisted entity that regularly issues options or shares to employees (or other parties) might have set up an internal market for its shares. The volatility of those share prices could be considered when estimating expected volatility.

B29 Alternatively, the entity could consider the historical or implied volatility of similar listed entities, for which share price or option price information is available, to use when estimating expected volatility. This would be appropriate if the entity has based the value of its shares on the share prices of similar listed entities.

B30 If the entity has not based its estimate of the value of its shares on the share prices of similar listed entities, and has instead used another valuation methodology to value its shares, the entity could derive an estimate of expected volatility consistent with that valuation methodology. For example, the entity might value its shares on a net asset or earnings basis. It could consider the expected volatility of those net asset values or earnings.

Expected dividends

B31 Whether expected dividends should be taken into account when measuring the fair value of shares or options granted depends on whether the counterparty is entitled to dividends or dividend equivalents.

B32 For example, if employees were granted options and are entitled to dividends on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividends will be paid on the underlying shares, i.e. the input for expected dividends should be zero.

B33 Similarly, when the grant date fair value of shares granted to employees is estimated, no adjustment is required for expected dividends if the employee is entitled to receive dividends paid during the vesting period.

B34 Conversely, if the employees are not entitled to dividends or dividend equivalents during the vesting period (or before exercise, in the case of an option), the grant date valuation of the rights to shares or options should take expected dividends into account. That is to say, when the fair value of an option grant is estimated, expected dividends should be included in the application of an option pricing model. When the fair value of a share grant is estimated, that valuation should be reduced by the present value of dividends expected to be paid during the vesting period.

© Copyright

B35 Option pricing models generally call for expected dividend yield. However, the models may be modified to use an expected dividend amount rather than a yield. An entity may use either its expected yield or its expected payments. If the entity uses the latter, it should consider its historical pattern of increases in dividends. For example, if an entity's policy has generally been to increase dividends by approximately 3 per cent per year, its estimated option value should not assume a fixed dividend amount throughout the option's life unless there is evidence that supports that assumption.

B36 Generally, the assumption about expected dividends should be based on publicly available information. An entity that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. However, an emerging entity with no history of paying dividends might expect to begin paying dividends during the expected lives of its employee share options. Those entities could use an average of their past dividend yield (zero) and the mean dividend yield of an appropriately comparable peer group.

Risk-free interest rate

B37 Typically, the risk-free interest rate is the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk-free interest rate (for example, in high inflation economies). Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

Capital structure effects

B38 Typically, third parties, not the entity, write traded share options. When these share options are exercised, the writer delivers shares to the option holder. Those shares are acquired from existing shareholders. Hence the exercise of traded share options has no dilutive effect.

B39 In contrast, if share options are written by the entity, new shares are issued when those share options are exercised (either actually issued or issued in substance, if shares previously repurchased and held in treasury are used). Given that the shares will be issued at the exercise price rather than the current market price at the date of exercise, this actual or potential dilution might reduce the share price, so that the option holder does not make as large a gain on exercise as on exercising an otherwise similar traded option that does not dilute the share price.

B40 Whether this has a significant effect on the value of the share options granted depends on various factors, such as the number of new shares that will be issued on exercise of the options compared with the number of shares already issued. Also, if the market already expects that the option grant will take place, the market may have already factored the potential dilution into the share price at the date of grant.

© Copyright

B41 However, the entity should consider whether the possible dilutive effect of the future exercise of the share options granted might have an impact on their estimated fair value at grant date. Option pricing models can be adapted to take into account this potential dilutive effect.

Modifications to equity-settled share-based payment arrangements

B42 Paragraph 27 requires that, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity should recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. In addition, the entity should recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

B43 To apply the requirements of paragraph 27:

(a) if the modification increases the fair value of the equity instruments granted (e.g. by reducing the exercise price), measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the equity instruments granted. The incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period. If the modification occurs after vesting date, the incremental fair value granted is recognised immediately, or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified equity instruments.

(b) similarly, if the modification increases the number of equity instruments granted, the entity shall include the fair value of the additional equity instruments granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the equity instruments granted, consistently with the requirements in (a) above. For example, if the modification occurs during the vesting period, the fair value of the additional equity instruments granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional equity instruments vest, in addition to the amount based on the grant date fair value of the equity instruments originally granted, which is recognised over the remainder of the original vesting period.

© Copyright

(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.

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.

B47 Four issues are commonly encountered in share-based payment transactions among group entities. For convenience, the examples below discuss the issues in terms of a parent and its subsidiary.

Share-based payment arrangements involving an entity's own equity instruments

B48 The first issue is whether the following transactions involving an entity's own equity instruments should be accounted for as equity-settled or as cash-settled in accordance with the requirements of this HKFRS:

(a) an entity grants to its employees rights to equity instruments of the entity (eg share options), and either chooses or is required to buy equity instruments (ie treasury shares) from another party, to satisfy its obligations to its employees; and

(b) an entity's employees are granted rights to equity instruments of the entity (eg share options), either by the entity itself or by its shareholders, and the shareholders of the entity provide the equity instruments needed.

B49 The entity shall account for share-based payment transactions in which it receives services as consideration for its own equity instruments as equity-settled. This applies regardless of whether the entity chooses or is required to buy those equity instruments from another party to satisfy its obligations to its employees under the share-based payment arrangement. It also applies regardless of whether:

(a) the employee's rights to the entity's equity instruments were granted by the entity itself or by its shareholder(s); or

(b) the share-based payment arrangement was settled by the entity itself or by its shareholder(s).

B50 If the shareholder has an obligation to settle the transaction with its investee's employees, it provides equity instruments of its investee rather than its own. Therefore, if its investee is in the same group as the shareholder, in accordance with paragraph 43C, the shareholder shall measure its obligation in accordance with the requirements applicable to cash-settled share-based payment transactions in the shareholder's separate financial statements and those applicable to equity-settled share-based payment transactions in the shareholder's consolidated financial statements.

Share-based payment arrangements involving equity instruments of the parent

B51 The second issue concerns share-based payment transactions between two or more entities within the same group involving an equity instrument of another group entity. For example, employees of a subsidiary are granted rights to equity instruments of its parent as consideration for the services provided to the subsidiary.

B52 Therefore, the second issue concerns the following share-based payment arrangements:

(a) a parent grants rights to its equity instruments directly to the employees of its subsidiary: the parent (not the subsidiary) has the obligation to provide the employees of the subsidiary with the equity instruments; and

(b) a subsidiary grants rights to equity instruments of its parent to its employees: the subsidiary has the obligation to provide its employees with the equity instruments.

A parent grants rights to its equity instruments to the employees of its subsidiary (paragraph B52(a))

B53 The subsidiary does not have an obligation to provide its parent's equity instruments to the subsidiary's employees. Therefore, in accordance with paragraph 43B, the subsidiary shall measure the services received from its employees in accordance with the requirements applicable to equity-settled share-based payment transactions, and recognise a corresponding increase in equity as a contribution from the parent.

B54 The parent has an obligation to settle the transaction with the subsidiary's employees by providing the parent's own equity instruments. Therefore, in accordance with paragraph 43C, the parent shall measure its obligation in accordance with the requirements applicable to equity-settled share-based payment transactions.

A subsidiary grants rights to equity instruments of its parent to its employees (paragraph B52(b))

B55 Because the subsidiary does not meet either of the conditions in paragraph 43B, it shall account for the transaction with its employees as cash-settled. This requirement applies irrespective of how the subsidiary obtains the equity instruments to satisfy its obligations to its employees.

Share-based payment arrangements involving cash-settled payments to employees

B56 The third issue is how an entity that receives goods or services from its suppliers (including employees) should account for share-based arrangements that are cash-settled when the entity itself does not have any obligation to make the required payments to its suppliers. For example, consider the following arrangements in which the parent (not the entity itself) has an obligation to make the required cash payments to the employees of the entity:

(a) the employees of the entity will receive cash payments that are linked to the price of its equity instruments.

(b) the employees of the entity will receive cash payments that are linked to the price of its parent's equity instruments.

B57 The subsidiary does not have an obligation to settle the transaction with its employees. Therefore, the subsidiary shall account for the transaction with its employees as equity-settled, and recognise a corresponding increase in equity as a contribution from its parent. The subsidiary shall remeasure the cost of the transaction subsequently for any changes resulting from non-market vesting conditions not being met in accordance with paragraphs 19–21. This differs from the measurement of the transaction as cash-settled in the consolidated financial statements of the group.

B58 Because the parent has an obligation to settle the transaction with the employees, and the consideration is cash, the parent (and the consolidated group) shall measure its obligation in accordance with the requirements applicable to cash-settled share-based payment transactions in paragraph 43C.

Transfer of employees between group entities

B59 The fourth issue relates to group share-based payment arrangements that involve employees of more than one group entity. For example, a parent might grant rights to its equity instruments to the employees of its subsidiaries, conditional upon the completion of continuing service with the group for a specified period. An employee of one subsidiary might transfer employment to another subsidiary during the specified vesting period without the employee's rights to equity instruments of the parent under the original share-based payment arrangement being affected. If the subsidiaries have no obligation to settle the share-based payment transaction with their employees, they account for it as an equity-settled transaction. Each subsidiary shall measure the services received from the employee by reference to the fair value of the equity instruments at the date the rights to those equity instruments were originally granted by the parent as defined in Appendix A, and the proportion of the vesting period the employee served with each subsidiary.

B60 If the subsidiary has an obligation to settle the transaction with its employees in its parent's equity instruments, it accounts for the transaction as cash-settled. Each subsidiary shall measure the services received on the basis of grant date fair value of the equity instruments for the proportion of the vesting period the employee served with each subsidiary. In addition, each subsidiary shall recognise any change in the fair value of the equity instruments during the employee's service period with each subsidiary.

B61 Such an employee, after transferring between group entities, may fail to satisfy a vesting condition other than a market condition as defined in Appendix A, eg the employee leaves the group before completing the service period. In this case, because the vesting condition is service to the group, each subsidiary shall adjust the amount previously recognised in respect of the services received from the employee in accordance with the principles in paragraph 19. Hence, if the rights to the equity instruments granted by the parent do not vest because of an employee's failure to meet a vesting condition other than a market condition, no amount is recognised on a cumulative basis for the services received from that employee in the financial statements of any group entity.

© Copyright

Appendix C

Amendments to other HKFRSs

The amendments in this appendix shall be applied for accounting periods beginning on or after 1 January 2005. If an entity applies 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 ~~E~~D

Comparison with International Financial Reporting 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 HKFRS 2.

The International Financial Reporting Standard comparable with HKFRS 2 is IFRS 2 *Share-based Payment.*

There are no major textual differences between HKFRS 2 and IFRS 2.

© Copyright

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

Basis for Conclusions
HKFRS 2 *Share-based Payment*

HKFRS 2 is based on IFRS 2 *Share-based Payment*. In approving HKFRS 2, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 2. Accordingly, there are no significant differences between HKFRS 2 and IFRS 2. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 2 referred to below generally correspond with those in HKFRS 2.

CONTENTS

paragraphs

BASIS FOR CONCLUSIONS ON HKFRS 2 *SHARE-BASED PAYMENT*

INTRODUCTION	**BC1-BC6A**
SCOPE	**BC7-BC28**
Broad-based employee share plans, including employee share purchase plans	**BC8-BC18**
Transaction in which an entity cannot identify some or all of the goods or services received	**BC18A-BC18D**
Transfers of equity instruments to employees	**BC19-BC22G**
Transactions within the scope of IFRS 3 *Business Combinations*	**BC23-BC24D**
Transactions within the scope of IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*	**BC25-BC28**
RECOGNITION OF EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS	**BC29-BC60**
'The entity is not a party to the transaction'	**BC34-BC35**
'The employees do not provide services'	**BC36-BC39**
'There is no cost to the entity, therefore there is no expense'	**BC40-BC44**
'Expense recognition is inconsistent with the definition of an expense'	**BC45-BC53**
'Earnings per share is "hit twice"'	**BC54-BC57**
'Adverse economic consequences'	**BC58-BC60**
MEASUREMENT OF EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS	**BC61-BC128H**

Measurement basis	**BC69-BC87**
Historical cost	BC70-BC74
Intrinsic value	BC75-BC79
Minimum value	BC80-BC83
Fair value	BC84-BC87
Measurement date	**BC88-BC128H**
The debit side of the transaction	BC91-BC96
The credit side of the transaction	BC97-BC105
Exercise date	BC98
Vesting date, service date and grant date	BC99-BC105
Other issues	BC106-BC118
IAS 32 Financial Instruments: Presentation	BC106-BC110
Suggestions to change the definitions of liabilities and equity	BC111-BC118
Share-based payment transactions with parties other than employees	BC119-BC128
Transactions in which the entity cannot indentify specifically some or all of the goods or services received	BC128A-BC128H
FAIR VALUE OF EMPLOYEE SHARE OPTIONS	**BC129-BC199**
Application of option pricing models to unlisted and newly listed entities	**BC137-BC144**
Application of option pricing models to employee share options	**BC145-BC199**
Inability to exercise during the vesting period	BC146-BC152
Non-transferability	BC153-BC169
Vesting conditions	BC170-BC184
Option term	BC185-BC187
Other features of employee share options	BC188-BC199
RECOGNITION AND MEASUREMENT OF SERVICES RECEIVED IN AN EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTION	**BC200-BC221**
During the vesting period	**BC200-BC217**
Share options that are forfeited or lapse after the end of the vesting period	**BC218-BC221**
MODIFICATIONS TO THE TERMS AND CONDITIONS OF SHARE-BASED PAYMENT ARRANGEMENTS	**BC222-BC237B**
SHARE APPRECIATION RIGHTS SETTLED IN CASH	**BC238-BC255**
Is there a liability before vesting date?	**BC243-BC245**
How should the liability be measured?	**BC246-BC251**
How should the associated expense be presented in the income statement?	**BC252-BC255**

SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES **BC256-BC268**

The terms of the arrangement provide the employee with a choice of settlement **BC258-BC264**

The terms of the arrangement provide the entity with a choice of settlement **BC265-BC268**

SHARE-BASED PAYMENT TRANSACTIONS AMONG GROUP ENTITIES (2009 AMENDMENTS) **BC268A-BC268S**

TRANSFER OF EMPLOYEES BETWEEN GROUP ENTITIES **BC268P-BC268S**

OVERALL CONCLUSIONS ON ACCOUNTING FOR EMPLOYEE SHARE OPTIONS **BC269-BC310**

Convergence with US GAAP **BC270-BC286**

APB 25 BC272-BC275
SFAS 123 BC276-BC286

Recognition versus disclosure **BC287-BC293**

Reliability of measurement **BC294-BC310**

TRANSITIONAL PROVISIONS **BC310A**

Share-based payment transactions among group entities **BC310A**

CONSEQUENTIAL AMENDMENTS TO OTHER STANDARDS **BC311-BC333**

Tax effects of share-based payment transactions **BC311-BC329**

Accounting for own shares held **BC330-BC333**

APPENDIX:

~~**Amendments to Basis for Conclusions on HKFRS 2 – *Group Cash-settled Share-based Payment Transactions***~~

Amendments resulting from other Basis for Conclusions

Basis for Conclusions on

IFRS 2 *Share-based Payment*

This Basis for Conclusions accompanies, but is not part of, IFRS 2.

INTRODUCTION

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 2 *Share-based Payment*. Individual Board members gave greater weight to some factors than to others.

BC2 Entities often issue[*] shares or share options to pay employees or other parties. Share plans and share option plans are a common feature of employee remuneration, not only for directors and senior executives, but also for many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

BC3 Until the issue of IFRS 2, there has been no International Financial Reporting Standard (IFRS) covering the recognition and measurement of these transactions. Concerns have been raised about this gap in international standards. For example, the International Organization of Securities Commissions (IOSCO), in its 2000 report on international standards, stated that IASC (the IASB's predecessor body) should consider the accounting treatment of share-based payment.

BC4 Few countries have standards on the topic. This is a concern in many countries, because the use of share-based payment has increased in recent years and continues to spread. Various standard-setting bodies have been working on this issue. At the time the IASB added a project on share-based payment to its agenda in July 2001, some standard-setters had recently published proposals. For example, the German Accounting Standards Committee published a draft accounting standard *Accounting for Share Option Plans and Similar Compensation Arrangements* in June 2001. The UK Accounting Standards Board led the development of the Discussion Paper *Accounting for Share-based Payment*, published in July 2000 by IASC, the ASB and other bodies represented in the G4+1.[†] The Danish Institute of State Authorised Public Accountants issued a Discussion Paper *The Accounting Treatment of Share-based Payment* in April 2000. More recently, in December 2002, the Accounting Standards Board of Japan published a Summary Issues Paper on share-based payment. In March 2003, the US Financial Accounting Standards Board (FASB) added to its agenda a project to review US accounting requirements on share-based payment. Also, the Canadian Accounting Standards Board (AcSB) recently completed its project on share-based payment. The AcSB standard requires recognition of all share-based payment transactions, including transactions in which share options are granted to employees (discussed further in paragraphs BC281 and BC282).

[*] The word 'issue' is used in a broad sense. For example, a transfer of shares held in treasury (own shares held) to another party is regarded as an 'issue' of equity instruments. Some argue that if options or shares are granted with vesting conditions, they are not 'issued' until those vesting conditions have been satisfied. However, even if this argument is accepted, it does not change the Board's conclusions on the requirements of the IFRS, and therefore the word 'issue' is used broadly, to include situations in which equity instruments are conditionally transferred to the counterparty, subject to the satisfaction of specified vesting conditions.

[†] The G4+1 comprised members of the national accounting standard-setting bodies of Australia, Canada, New Zealand, the UK and the US, and IASC.

BC5 Users of financial statements and other commentators are calling for improvements in the accounting treatment of share-based payment. For example, the proposal in the IASC/G4+1 Discussion Paper and ED 2 *Share-based Payment*, that share-based payment transactions should be recognised in the financial statements, resulting in an expense when the goods or services are consumed, received strong support from investors and other users of financial statements. Recent economic events have emphasised the importance of high quality financial statements that provide neutral, transparent and comparable information to help users make economic decisions. In particular, the omission of expenses arising from share-based payment transactions with employees has been highlighted by investors, other users of financial statements and other commentators as causing economic distortions and corporate governance concerns.

BC6 As noted above, the Board began a project to develop an IFRS on share-based payment in July 2001. In September 2001, the Board invited additional comment on the IASC/G4+1 Discussion Paper, with a comment deadline of 15 December 2001. The Board received over 270 letters. During the development of ED 2, the Board was also assisted by an Advisory Group, consisting of individuals from various countries and with a range of backgrounds, including persons from the investment, corporate, audit, academic, compensation consultancy, valuation and regulatory communities. The Board received further assistance from other experts at a panel discussion held in New York in July 2002. In November 2002, the Board published an Exposure Draft, ED 2 *Share-based Payment*, with a comment deadline of 7 March 2003. The Board received over 240 letters. The Board also worked with the FASB after that body added to its agenda a project to review US accounting requirements on share-based payment. This included participating in meetings of the FASB's Option Valuation Group and meeting the FASB to discuss convergence issues.

BC6A In 2007 the Board added to its agenda a project to clarify the scope and accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment. In December 2007 the Board published *Group Cash-settled Share-based Payment Transactions* (proposed amendments to IFRS 2). The resulting amendments issued in June 2009 also incorporate the requirements of two Interpretations—IFRIC 8 *Scope of IFRS 2* and IFRIC 11 *IFRS 2—Group and Treasury Share Transactions*. As a consequence, the Board withdrew both Interpretations.

Scope

BC7 Much of the controversy and complexity surrounding the accounting for share-based payment relates to employee share options. However, the scope of IFRS 2 is broader than that. It applies to transactions in which shares or other equity instruments are granted to employees. It also applies to transactions with parties other than employees, in which goods or services are received as consideration for the issue of shares, share options or other equity instruments. The term 'goods' includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. Lastly, the IFRS applies to payments in cash (or other assets) that are 'share-based' because the amount of the payment is based on the price of the entity's shares or other equity instruments, eg cash share appreciation rights.

Broad-based employee share plans, including employee share purchase plans

BC8 Some employee share plans are described as 'broad-based' or 'all-employee' plans, in which all (or virtually all) employees have the opportunity to participate, whereas other plans are more selective, covering individual or specific groups of employees (e.g. senior executives). Employee share purchase plans are often broad-based plans. Typically, employee share purchase plans provide employees with an opportunity to buy a specific number of shares at a discounted price, i.e. at an amount that is less than the fair value of the shares. The employee's entitlement to discounted shares is usually conditional upon specific conditions being satisfied, such as remaining in the service of the entity for a specified period.

BC9 The issues that arise with respect to employee share purchase plans are:

(a) are these plans somehow so different from other employee share plans that a different accounting treatment is appropriate?

(b) even if the answer to the above question is 'no', are there circumstances, such as when the discount is very small, when it is appropriate to exempt employee share purchase plans from an accounting standard on share-based payment?

BC10 Some respondents to ED 2 argued that broad-based employee share plans should be exempt from an accounting standard on share-based payment. The reason usually given was that these plans are different from other types of employee share plans and, in particular, are not a part of remuneration for employee services. Some argued that requiring the recognition of an expense in respect of these types of plans was perceived to be contrary to government policy to encourage employee share ownership. In contrast, other respondents saw no difference between employee share purchase plans and other employee share plans, and argued that the same accounting requirements should therefore apply. However, some suggested that there should be an exemption if the discount is small.

BC11 The Board concluded that, in principle, there is no reason to treat broad-based employee share plans, including broad-based employee share purchase plans, differently from other employee share plans (the issue of 'small' discounts is considered later). The Board noted that the fact that these schemes are available only to employees is in itself sufficient to conclude that the benefits provided represent employee remuneration. Moreover, the term 'remuneration' is not limited to remuneration provided as part of an individual employee's contract: it encompasses all benefits provided to employees. Similarly, the term services encompasses all benefits provided by the employees in return, including increased productivity, commitment or other enhancements in employee work performance as a result of the incentives provided by the share plan.

BC12 Moreover, distinguishing regular employee services from the additional benefits received from broad-based employee share plans would not change the conclusion that it is necessary to account for such plans. No matter what label is placed on the benefits provided by employees—or the benefits provided by the entity—the transaction should be recognised in the financial statements.

© Copyright

BC13 Furthermore, that governments in some countries have a policy of encouraging employee share ownership is not a valid reason for according these types of plans a different accounting treatment, because it is not the role of financial reporting to give favourable accounting treatment to particular transactions to encourage entities to enter into them. For example, governments might wish to encourage entities to provide pensions to their employees, to lessen the future burden on the state, but that does not mean that pension costs should be excluded from the financial statements. To do so would impair the quality of financial reporting. The purpose of financial reporting is to provide information to users of financial statements, to assist them in making economic decisions. The omission of expenses from the financial statements does not change the fact that those expenses have been incurred. The omission of expenses causes reported profits to be overstated and hence the financial statements are not neutral, are less transparent and comparable, and are potentially misleading to users.

BC14 There remains the question whether there should be an exemption for some plans, when the discount is small. For example, FASB Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation* contains an exemption for employee share purchase plans that meet specified criteria, of which one is that the discount is small.

BC15 On the one hand, it seems reasonable to exempt an employee share purchase plan if it has substantially no option features and the discount is small. In such situations, the rights given to the employees under the plan probably do not have a significant value, from the entity's perspective.

BC16 On the other hand, even if one accepts that an exemption is appropriate, specifying its scope is problematic, e.g. deciding what constitutes a small discount. Some argue that a 5 per cent discount from the market price (as specified in SFAS 123) is too high, noting that a block of shares can be sold on the market at a price close to the current share price. Furthermore, it could be argued that it is unnecessary to exempt these plans from the standard. If the rights given to the employees do not have a significant value, this suggests that the amounts involved are immaterial. Because it is not necessary to include immaterial information in the financial statements, there is no need for a specific exclusion in an accounting standard.

BC17 For the reasons given in the preceding paragraph, the Board concluded that broad-based employee share plans, including broad-based employee share purchase plans, should not be exempted from the IFRS.

BC18 However, the Board noted that there might be instances when an entity engages in a transaction with an employee in his/her capacity as a holder of equity instruments, rather than in his/her capacity as an employee. For example, an entity might grant 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. If an employee receives such a right because he/she is a holder of that particular class of equity instruments, the Board concluded that the granting or exercise of that right should not be subject to the requirements of the IFRS, because the employee has received that right in his/her capacity as a shareholder, rather than as an employee.

© Copyright

Transactions in which an entity cannot identify some or all of the goods or services received (paragraph 2)*

BC18A The Board incorporated into IFRS 2 the consensus of IFRIC 8 in *Group Cash-settled Share-based Payment Transactions* issued in June 2009. This section summarises the IFRIC's considerations in reaching that consensus, as approved by the Board.

BC18B IFRS 2 applies to share-based payment transactions in which the entity receives or acquires goods or services. However, in some situations it might be difficult to demonstrate that the entity has received goods or services. This raises the question of whether IFRS 2 applies to such transactions. In addition, if the entity has made a share-based payment and the identifiable consideration received (if any) appears to be less than the fair value of the share-based payment, does this situation indicate that goods or services have been received, even though those goods or services are not specifically identified, and therefore that IFRS 2 applies?

BC18C When the Board developed IFRS 2, it concluded that the directors of an entity would expect to receive some goods or services in return for equity instruments issued (paragraph BC37). This implies that it is not necessary to identify the specific goods or services received in return for the equity instruments granted to conclude that goods or services have been (or will be) received. Furthermore, paragraph 8 of the IFRS establishes that it is not necessary for the goods or services received to qualify for recognition as an asset in order for the share-based payment to be within the scope of IFRS 2. In this case, the IFRS requires the cost of the goods or services received or receivable to be recognised as expenses.

BC18D Accordingly, the Board concluded that the scope of IFRS 2 includes transactions in which the entity cannot identify some or all of the specific goods or services received. If the value of the identifiable consideration received appears to be less than the fair value of the equity instruments granted or liability incurred, typically,† this circumstance indicates that other consideration (ie unidentifiable goods or services) has been (or will be) received.

Transfers of equity instruments to employees (paragraphs 3 and 3A)⌖

BC19 In some situations, an entity might not issue shares or share options to employees (or other parties) direct. Instead, a shareholder (or shareholders) might transfer equity instruments to the employees (or other parties).

BC20 Under this arrangement, the entity has received services (or goods) that were paid for by its shareholders. The arrangement could be viewed as being, in substance, two transactions—one transaction in which the entity has reacquired equity instruments for nil consideration, and a second transaction in which the entity has received services (or

* Paragraphs BC18A—BC18D are added as a consequence of *Group Cash-settled Share-based Payment Transactions* (Amendments to IFRS 2) issued in June 2009.

† In some cases, the reason for the transfer would explain why no goods or services have been or will be received. For example, a principal shareholder, as part of estate planning, transfers some of his shares to a family member. In the absence of factors that indicate that the family member has provided, or is expected to provide, any goods or services to the entity in return for the shares, such a transaction would be outside the scope of IFRS 2.

⌖ Paragraphs BC22A—BC22G are added as a consequence of *Group Cash-settled Share-based Payment Transactions* (Amendments to IFRS 2) issued in June 2009.

goods) as consideration for equity instruments issued to the employees (or other parties).

BC21 The second transaction is a share-based payment transaction. Therefore, the Board concluded that the entity should account for transfers of equity instruments by shareholders to employees or other parties in the same way as other share-based payment transactions. The Board reached the same conclusion with respect to transfers of equity instruments of the entity's parent, or of another entity within the same group as the entity, to the entity's employees or other suppliers.

BC22 However, such a transfer is not a share-based payment transaction if the transfer of equity instruments to an employee or other party is clearly for a purpose other than payment for goods or services supplied to the entity. This would be the case, for example, if the transfer is to settle a shareholder's personal obligation to an employee that is unrelated to employment by the entity, or if the shareholder and employee are related and the transfer is a personal gift because of that relationship.

BC22A In December 2007 the Board published an exposure draft *Group Cash-settled Share-based Payment Transactions* proposing amendments to IFRS 2 and IFRIC 11 to clarify the accounting for such transactions in the separate or individual financial statements of the entity receiving goods or services. The Board proposed to include specified types of such transactions within the scope of IFRS 2 (not IAS 19 *Employee Benefits*), regardless of whether the group share-based payment transaction is cash-settled or equity-settled.

BC22B Nearly all of the respondents to the exposure draft agreed that the group cash-settled transactions between a parent and a subsidiary described in the exposure draft should be within the scope of IFRS 2. Respondents generally believed that including these transactions is consistent with IFRS 2's main principle that the entity should recognise the goods or services that it receives in a share-based transaction. However, respondents also expressed concerns that the proposed scope:

(a) adopted a case-by-case approach and was inconsistent with the definitions of share-based payment transactions in IFRS 2.

(b) was unclear and increased the inconsistency in the scope requirements among the applicable IFRSs, including IFRIC 11.

BC22C Many respondents expressed concerns that similar transactions would continue to be treated differently. Because no amendments to the definitions of share-based payment transactions were proposed, some transactions might not be included within the scope of IFRS 2 because they did not meet those definitions. The Board agreed with respondents that the proposals did not achieve the objective of including all share-based payment transactions within the scope of IFRS 2 as intended.

BC22D When finalising the amendments issued in June 2009, the Board reaffirmed the view it had intended to convey in the proposed amendments, namely that the entity receiving the goods or services should account for group share-based payment transactions in accordance with IFRS 2. Consequently, IFRS 2 applies even when the entity receiving the goods or services has no obligation to settle the transaction and regardless of whether the payments to the suppliers are equity-settled or cash-settled. To avoid the need for further guidance on the scope of IFRS 2 for group transactions, the Board decided to amend some of the defined terms and to supersede paragraph 3 by a new paragraph 3A to state clearly the principles applicable to those transactions.

BC22E During its redeliberations of the proposed amendments, the Board agreed with respondents' comments that, as proposed, the scope of IFRS 2 remained unclear and inconsistent between the standard and related Interpretations. For example, the terms 'shareholder' and 'parent' have different meanings: a shareholder is not necessarily a parent, and a parent does not have to be a shareholder. The Board noted that share-based payment transactions among group entities are often directed by the parent, indicating a level of control. Therefore, the Board clarified the boundaries of a 'group' by adopting the same definition as in paragraph 4 of IAS 27 *Consolidated and Separate Financial Statements*, which includes only a parent and its subsidiaries.

BC22F Some respondents to the exposure draft questioned whether the proposals should apply to joint ventures. Before the Board's amendments, the guidance in paragraph 3 (now superseded by paragraph 3A) stated that when a shareholder transferred equity instruments of the entity (or another group entity), the transaction would be within the scope of IFRS 2 for the entity receiving the goods or services. However, that guidance did not specify the accounting by a shareholder transferor. The Board noted that the defined terms in Appendix A, as amended, would clearly state that any entity (including a joint venture) that receives goods or services in a share-based payment transaction should account for the transaction in accordance with the IFRS, regardless of whether that entity also settles the transaction.

BC22G Furthermore, the Board noted that the exposure draft and related discussions focused on clarifying guidance for transactions involving group entities in the separate or individual financial statements of the entity receiving the goods or services. Addressing transactions involving related parties outside a group structure in their separate or individual financial statements would significantly expand the scope of the project and change the scope of IFRS 2. Therefore, the Board decided not to address transactions between entities not in the same group that are similar to share-based payment transactions but outside the definitions as amended. This carries forward the existing guidance of IFRS 2 for entities not in the same group and the Board does not intend to change that guidance.

Transactions within the scope of IFRS 3 *Business Combinations*

BC23 An entity might acquire goods (or other non-financial assets) as part of the net assets acquired in a business combination for which the consideration paid included shares or other equity instruments issued by the entity. Because IFRS 3 applies to the acquisition of assets and issue of shares in connection with a business combination, that is the more specific standard that should be applied to that transaction.

BC24 Therefore, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of IFRS 2. 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 IFRS 2. Also, the cancellation, replacement, or other modifications to share-based payment arrangements because of a business combination or other equity restructuring should be accounted for in accordance with IFRS 2.

BC24A IFRS 3 (as revised in 2008) changed the definition of a business combination. The previous definition of a business combination was 'the bringing together of separate entities or businesses into one reporting entity'. The revised definition of a business combination is 'a transaction or other event in which an acquirer obtains control of one or more businesses'.

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

* The title of IAS 32 was amended in 2005.

that is the subject of the contract is readily convertible to cash (IAS 32, paragraphs 8-10 and IAS 39, paragraphs 5-7).

BC28 The Board concluded that the contracts discussed in paragraph BC27 should remain within the scope of IAS 32 and IAS 39 and they are therefore excluded from the scope of IFRS 2.

Recognition of equity-settled share-based payment transactions

BC29 When it developed ED 2, the Board first considered conceptual arguments relating to the recognition of an expense arising from equity-settled share-based payment transactions, including arguments advanced by respondents to the Discussion Paper and other commentators. Some respondents who disagreed with the recognition of an expense arising from particular share-based payment transactions (i.e. those involving employee share options) did so for practical, rather than conceptual, reasons. The Board considered those practical issues later (see paragraphs BC294-BC310).

BC30 The Board focused its discussions on employee share options, because that is where most of the complexity and controversy lies, but the question of whether expense recognition is appropriate is broader than that – it covers all transactions involving the issue of shares, share options or other equity instruments to employees or suppliers of goods and services. For example, the Board noted that arguments made by respondents and other commentators against expense recognition are directed solely at employee share options. However, if conceptual arguments made against recognition of an expense in relation to employee share options are valid (eg that there is no cost to the entity), those arguments ought to apply equally to transactions involving other equity instruments (eg shares) and to equity instruments issued to other parties (eg suppliers of professional services).

BC31 The rationale for recognising all types of share-based payment transactions—irrespective of whether the equity instrument is a share or a share option, and irrespective of whether the equity instrument is granted to an employee or to some other party—is that the entity has engaged in a transaction that is in essence the same as any other issue of equity instruments. In other words, the entity has received resources (goods or services) as consideration for the issue of shares, share options or other equity instruments. It should therefore account for the inflow of resources (goods or services) and the increase in equity. Subsequently, either at the time of receipt of the goods or services or at some later date, the entity should also account for the expense arising from the consumption of those resources.

BC32 Many respondents to ED 2 agreed with this conclusion. Of those who disagreed, some disagreed in principle, some disagreed for practical reasons, and some disagreed for both reasons. The arguments against expense recognition in principle were considered by the Board when it developed ED 2, as were the arguments against expense recognition for practical reasons, as explained below and in paragraphs BC294-BC310.

BC33 Arguments commonly made against expense recognition include:

(a) the transaction is between the shareholders and the employees, not the entity and the employees.

(b) the employees do not provide services for the options.

© Copyright

(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.

BC38 Typically, shares or share options granted to employees form one part of their remuneration package. For example, an employee might have a remuneration package consisting of a basic cash salary, company car, pension, healthcare benefits, and other benefits including shares and share options. It is usually not possible to identify the services received in respect of individual components of that remuneration package, e.g. the services received in respect of healthcare benefits. But that does not mean that the employee does not provide services for those healthcare benefits. Rather, the employee provides services for the entire remuneration package.

BC39 In summary, shares, share options or other equity instruments are granted to employees because they are employees. The equity instruments granted form a part of their total remuneration package, regardless of whether that represents a large part or a small part.

‘There is no cost to the entity, therefore there is no expense’

BC40 Some argue that because share-based payments do not require the entity to sacrifice any cash or other assets, there is no cost to the entity, and therefore no expense should be recognised.

BC41 The Board regards this argument as unsound, because it overlooks that:

(a) every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and

(b) the expense arises from the consumption of those resources, not from an outflow of assets.

BC42 In other words, irrespective of whether one accepts that there is a cost to the entity, an accounting entry is required to recognise the resources received as consideration for the issue of equity instruments, just as it is on other occasions when equity instruments are issued. For example, when shares are issued for cash, an entry is required to recognise the cash received. If a non-monetary asset, such as plant and machinery, is received for those shares instead of cash, an entry is required to recognise the asset received. If the entity acquires another business or entity by issuing shares in a business combination, the entity recognises the net assets acquired.

BC43 The recognition of an expense arising out of such a transaction represents the consumption of resources received, ie the ‘using up’ of the resources received for the shares or share options. In the case of the plant and machinery mentioned above, the asset would be depreciated over its expected life, resulting in the recognition of an expense each year. Eventually, the entire amount recognised for the resources received when the shares were issued would be recognised as an expense (including any residual value, which would form part of the measurement of the gain or loss on disposal of the asset). Similarly, if another business or entity is acquired by an issue of shares, an expense is recognised when the assets acquired are consumed. For example, inventories acquired will be recognised as an expense when sold, even though no cash or other assets were disbursed to acquire those inventories.

© Copyright

BC44 The only difference in the case of employee services (or other services) received as consideration for the issue of shares or share options is that usually the resources received are consumed immediately upon receipt. This means that an expense for the consumption of resources is recognised immediately, rather than over a period of time. The Board concluded that the timing of consumption does not change the principle; the financial statements should recognise the receipt and consumption of resources, even when consumption occurs at the same time as, or soon after, receipt. This point is discussed further in paragraphs BC45-BC53.

'Expense recognition is inconsistent with the definition of an expense'

BC45 Some have questioned whether recognition of an expense arising from particular share-based payment transactions is consistent with accounting standard-setters' conceptual frameworks, in particular, the *Framework*, which states:

> Expenses are decreases in economic benefits during the accounting period in the form of outflows or *depletions of assets* or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. (paragraph 70, emphasis added)

BC46 Some argue that if services are received in a share-based payment transaction, there is no transaction or event that meets the definition of an expense. They contend that there is no outflow of assets and that no liability is incurred. Furthermore, because services usually do not meet the criteria for recognition as an asset, it is argued that the consumption of those services does not represent a depletion of assets.

BC47 The *Framework* defines an asset and explains that the term 'asset' is not limited to resources that can be recognised as assets in the balance sheet (*Framework*, paragraphs 49 and 50). Although services to be received in the future might not meet the definition of an asset,[*] services are assets when received. These assets are usually consumed immediately. This is explained in FASB Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements*:

> Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily – as the entity receives and uses them - although their use may create or add value to other assets of the entity… (paragraph 31)

BC48 This applies to all types of services, e.g. employee services, legal services and telephone services. It also applies irrespective of the form of payment. For example, if an entity purchases services for cash, the accounting entry is:

Dr Services received
  Cr Cash paid

BC49 Sometimes, those services are consumed in the creation of a recognisable asset, such as inventories, in which case the debit for services received is capitalised as part of a recognised asset. But often the services do not create or form part of a recognisable asset, in which case the debit for services received is charged immediately to the income statement as an expense. The debit entry above (and the resulting expense) does not represent the cash outflow - that is what the credit entry was for. Nor does it represent some sort of balancing item, to make the accounts balance. The debit entry above represents the resources received, and the resulting expense represents the consumption of those resources.

[*] For example, the entity might not have control over future services.

BC50 The same analysis applies if the services are acquired with payment made in shares or share options. The resulting expense represents the consumption of services, i.e. a depletion of assets.

BC51 To illustrate this point, suppose that an entity has two buildings, both with gas heating, and the entity issues shares to the gas supplier instead of paying cash. Suppose that, for one building, the gas is supplied through a pipeline, and so is consumed immediately upon receipt. Suppose that, for the other building, the gas is supplied in bottles, and is consumed over a period of time. In both cases, the entity has received assets as consideration for the issue of equity instruments, and should therefore recognise the assets received, and a corresponding contribution to equity. If the assets are consumed immediately (the gas received through the pipeline), an expense is recognised immediately; if the assets are consumed later (the gas received in bottles), an expense is recognised later when the assets are consumed.

BC52 Therefore, the Board concluded that the recognition of an expense arising from share-based payment transactions is consistent with the definition of an expense in the *Framework*.

BC53 The FASB considered the same issue and reached the same conclusion in SFAS 123:

> Some respondents pointed out that the definition of expenses in FASB Concepts Statement No. 6, *Elements of Financial Statements*, says that expenses result from outflows or using up of assets or incurring of liabilities (or both). They asserted that because the issuance of stock options does not result in the incurrence of a liability, no expense should be recognised. The Board agrees that employee stock options are not a liability—like stock purchase warrants, employee stock options are equity instruments of the issuer. However, equity instruments, including employee stock options, are valuable financial instruments and thus are issued for valuable consideration, which…for employee stock options is employee services. Using in the entity's operations the benefits embodied in the asset received results in an expense… (Concepts Statement 6, paragraph 81, footnote 43, notes that, in concept most expenses decrease assets. However, if receipt of an asset, such as services, and its use occur virtually simultaneously, the asset often is not recorded.) [paragraph 88]

'Earnings per share is "hit twice"'

BC54 Some argue that any cost arising from share-based payment transactions is already recognised in the dilution of earnings per share (EPS). If an expense were recognised in the income statement, EPS would be 'hit twice'.

BC55 However, the Board noted that this result is appropriate. For example, if the entity paid the employees in cash for their services and the cash was then returned to the entity, as consideration for the issue of share options, the effect on EPS would be the same as issuing those options direct to the employees.

BC56 The dual effect on EPS simply reflects the two economic events that have occurred: the entity has issued shares or share options, thereby increasing the number of shares included in the EPS calculation— although, in the case of options, only to the extent that the options are regarded as dilutive—and it has also consumed the resources it received for those options, thereby decreasing earnings. This is illustrated by the plant and machinery example mentioned in paragraphs BC42 and BC43. Issuing shares affects the number of shares in the EPS calculation, and the consumption (depreciation) of the asset affects earnings.

© Copyright

BC57 In summary, the Board concluded that the dual effect on diluted EPS is not double-counting the effects of a share or share option grant—the same effect is not counted twice. Rather, two different effects are each counted once.

'Adverse economic consequences'

BC58 Some argue that to require recognition (or greater recognition) of employee share-based payment would have adverse economic consequences, in that it might discourage entities from introducing or continuing employee share plans.

BC59 Others argue that if the introduction of accounting changes did lead to a reduction in the use of employee share plans, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans. They argue that this would correct the present economic distortion, whereby entities obtain and consume resources by issuing valuable shares or share options without accounting for those transactions.

BC60 In any event, the Board noted that the role of accounting is to report transactions and events in a neutral manner, not to give 'favourable' treatment to particular transactions to encourage entities to engage in those transactions. To do so would impair the quality of financial reporting. The omission of expenses from the financial statements does not change the fact that those expenses have been incurred. Hence, if expenses are omitted from the income statement, reported profits are overstated. The financial statements are not neutral, are less transparent and are potentially misleading to users. Comparability is impaired, given that expenses arising from employee share-based payment transactions vary from entity to entity, from sector to sector, and from year to year. More fundamentally, accountability is impaired, because the entities are not accounting for transactions they have entered into and the consequences of those transactions.

Measurement of equity-settled share-based payment transactions

BC61 To recognise equity-settled share-based payment transactions, it is necessary to decide how the transactions should be measured. The Board began by considering how to measure share-based payment transactions in principle. Later, it considered practical issues arising from the application of its preferred measurement approach. In terms of accounting principles, there are two basic questions:

(a) which measurement basis should be applied?

(b) when should that measurement basis be applied?

BC62 To answer these questions, the Board considered the accounting principles applying to equity transactions. The *Framework* states:

> Equity is the residual interest in the assets of the enterprise after deducting all of its liabilities…The amount at which equity is shown in the balance sheet is dependent upon the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise… (paragraphs 49 and 67)

BC63 The accounting equation that corresponds to this definition of equity is:

assets minus liabilities equals equity

BC64 Equity is a residual interest, dependent on the measurement of assets and liabilities. Therefore, accounting focuses on recording changes in the left side of the equation (assets minus liabilities, or net assets), rather than the right side. Changes in equity arise from changes in net assets. For example, if an entity issues shares for cash, it recognises the cash received and a corresponding increase in equity. Subsequent changes in the market price of the shares do not affect the entity's net assets and therefore those changes in value are not recognised.

BC65 Hence, the Board concluded that, when accounting for an equity-settled share-based payment transaction, the primary accounting objective is to account for the goods or services received as consideration for the issue of equity instruments. Therefore, equity-settled share-based payment transactions should be accounted for in the same way as other issues of equity instruments, by recognising the consideration received (the change in net assets), and a corresponding increase in equity.

BC66 Given this objective, the Board concluded that, in principle, the goods or services received should be measured at their fair value at the date when the entity obtains those goods or as the services are received. In other words, because a change in net assets occurs when the entity obtains the goods or as the services are received, the fair value of those goods or services at that date provides an appropriate measure of the change in net assets.

BC67 However, for share-based payment transactions with employees, it is usually difficult to measure directly the fair value of the services received. As noted earlier, typically shares or share options are granted to employees as one component of their remuneration package. It is usually not possible to identify the services rendered in respect of individual components of that package. It might also not be possible to measure independently the fair value of the total package, without measuring directly the fair value of the equity instruments granted. Furthermore, options or shares are sometimes granted as part of a bonus arrangement, rather than as a part of basic remuneration, eg as an incentive to the employees to remain in the entity's employ, or to reward them for their efforts in improving the entity's performance. By granting share options, in addition to other remuneration, the entity is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult.

BC68 Given these practical difficulties in measuring directly the fair value of the employee services received, the Board concluded that it is necessary to measure the other side of the transaction, i.e. the fair value of the equity instruments granted, as a surrogate measure of the fair value of the services received. In this context, the Board considered the same basic questions, as mentioned above:

(a) which measurement basis should be applied?

(b) when should that measurement basis be applied?

© Copyright

Measurement basis

BC69 The Board discussed the following measurement bases, to decide which should be applied in principle:

(a) historical cost

(b) intrinsic value

(c) minimum value

(d) fair value.

Historical cost

BC70 In jurisdictions where legislation permits, entities commonly repurchase their own shares, either directly or through a vehicle such as a trust, which are used to fulfil promised grants of shares to employees or the exercise of employee share options. A possible basis for measuring a grant of options or shares would be the historical cost (purchase price) of its own shares that an entity holds (own shares held), even if they were acquired before the award was made.

BC71 For share options, this would entail comparing the historical cost of own shares held with the exercise price of options granted to employees. Any shortfall would be recognised as an expense. Also, presumably, if the exercise price exceeded the historical cost of own shares held, the excess would be recognised as a gain.

BC72 At first sight, if one simply focuses on the cash flows involved, the historical cost basis appears reasonable: there is a cash outflow to acquire the shares, followed by a cash inflow when those shares are transferred to the employees (the exercise price), with any shortfall representing a cost to the entity. If the cash flows related to anything other than the entity's own shares, this approach would be appropriate. For example, suppose ABC Ltd bought shares in another entity, XYZ Ltd, for a total cost of CU500,000,[*] and later sold the shares to employees for a total of CU400,000. The entity would recognise an expense for the CU100,000 shortfall.

BC73 But when this analysis is applied to the entity's own shares, the logic breaks down. The entity's own shares are not an asset of the entity.[+] Rather, the shares are an interest in the entity's assets. Hence, the distribution of cash to buy back shares is a return of capital to shareholders, and should therefore be recognised as a decrease in equity. Similarly, when the shares are subsequently reissued or transferred, the inflow of cash

[*] All monetary amounts in this Basis for Conclusions are denominated in 'currency units' (CU).

[+] The Discussion Paper discusses this point:
Accounting practice in some jurisdictions may present own shares acquired as an asset, but they lack the essential feature of an asset – the ability to provide future economic benefits. The future economic benefits usually provided by an interest in shares are the right to receive dividends and the right to gain from an increase in value of the shares. When a company has an interest in its own shares, it will receive dividends on those shares only if it elects to pay them, and such dividends do not represent a gain to the company, as there is no change in net assets: the flow of funds is simply circular. Whilst it is true that a company that holds its own shares in treasury may sell them and receive a higher amount if their value has increased, a company is generally able to issue shares to third parties at (or near) the current market price. Although there may be legal, regulatory or administrative reasons why it is easier to sell shares that are held as treasury shares than it would be to issue new shares, such considerations do not seem to amount to a fundamental contrast between the two cases. (Footnote to paragraph 4.7)

is an increase in shareholders' capital, and should therefore be recognised as an increase in equity. It follows that no revenue or expense should be recognised. Just as the issue of shares does not represent revenue to the entity, the repurchase of those shares does not represent an expense.

BC74 Therefore, the Board concluded that historical cost is not an appropriate basis upon which to measure equity-settled share-based payment transactions.

Intrinsic value

BC75 An equity instrument could be measured at its intrinsic value. The intrinsic value of a share option at any point in time is the difference between the market price of the underlying shares and the exercise price of the option.

BC76 Often, employee share options have zero intrinsic value at the date of grant—commonly the exercise price is at the market value of the shares at grant date. Therefore, in many cases, valuing share options at their intrinsic value at grant date is equivalent to attributing no value to the options.

BC77 However, the intrinsic value of an option does not fully reflect its value. Options sell in the market for more than their intrinsic value. This is because the holder of an option need not exercise it immediately and benefits from any increase in the value of the underlying shares. In other words, although the ultimate benefit realised by the option holder is the option's intrinsic value at the date of exercise, the option holder is able to realise that future intrinsic value because of having held the option. Thus, the option holder benefits from the right to participate in future gains from increases in the share price. In addition, the option holder benefits from the right to defer payment of the exercise price until the end of the option term. These benefits are commonly referred to as the option's 'time value'.

BC78 For many options, time value represents a substantial part of their value. As noted earlier, many employee share options have zero intrinsic value at grant date, and hence the option's value consists entirely of time value. In such cases, ignoring time value by applying the intrinsic value method at grant date understates the value of the option by 100 per cent.

BC79 The Board concluded that, in general, the intrinsic value measurement basis is not appropriate for measuring share-based payment transactions, because omitting the option's time value ignores a potentially substantial part of an option's total value. Measuring share-based payment transactions at such an understated value would fail to represent those transactions faithfully in the financial statements.

Minimum value

BC80 A share option could be measured at its minimum value. Minimum value is based on the premise that someone who wants to buy a call option on a share would be willing to pay at least (and the option writer would demand at least) the value of the right to defer payment of the exercise price until the end of the option's term. Therefore, minimum value can be calculated using a present value technique. For a dividend-paying share, the calculation is:

(a) the current price of the share, minus

(b) the present value of expected dividends on that share during the option term (if the option holder does not receive dividends), minus

(c) the present value of the exercise price.

BC81 Minimum value can also be calculated using an option pricing model with an expected volatility of effectively zero (not exactly zero, because some option pricing models use volatility as a divisor, and zero cannot be a divisor).

BC82 The minimum value measurement basis captures part of the time value of options, being the value of the right to defer payment of the exercise price until the end of the option's term. It does not capture the effects of volatility. Option holders benefit from volatility because they have the right to participate in gains from increases in the share price during the option term without having to bear the full risk of loss from decreases in the share price. By ignoring volatility, the minimum value method produces a value that is lower, and often much lower, than values produced by methods designed to estimate the fair value of an option.

BC83 The Board concluded that minimum value is not an appropriate measurement basis, because ignoring the effects of volatility ignores a potentially large part of an option's value. As with intrinsic value, measuring share-based payment transactions at the option's minimum value would fail to represent those transactions faithfully in the financial statements.

Fair value

BC84 Fair value is already used in other areas of accounting, including other transactions in which non-cash resources are acquired through the issue of equity instruments. For example, consideration transferred in a business combination is measured at fair value, including the fair value of any equity instruments issued by the entity.

BC85 Fair value, which is the amount at which an equity instrument granted could be exchanged between knowledgeable, willing parties in an arm's length transaction, captures both intrinsic value and time value and therefore provides a measure of the share option's total value (unlike intrinsic value or minimum value). It is the value that reflects the bargain between the entity and its employees, whereby the entity has agreed to grant share options to employees for their services to the entity. Hence, measuring share-based payment transactions at fair value ensures that those transactions are represented faithfully in the financial statements, and consistently with other transactions in which the entity receives resources as consideration for the issue of equity instruments.

BC86 Therefore, the Board concluded that shares, share options or other equity instruments granted should be measured at their fair value.

© Copyright

BC87 Of the respondents to ED 2 who addressed this issue, many agreed with the proposal to measure the equity instruments granted at their fair value. Some respondents who disagreed with the proposal, or who agreed with reservations, expressed concerns about measurement reliability, particularly in the case of smaller or unlisted entities. The issues of measurement reliability and unlisted entities are discussed in paragraphs BC294-BC310 and BC137-BC144, respectively.

Measurement date

BC88 The Board first considered at which date the fair value of equity instruments should be determined for the purpose of measuring share-based payment transactions with employees (and others providing similar services).[*] The possible measurement dates discussed were grant date, service date, vesting date and exercise date. Much of this discussion was in the context of share options rather than shares or other equity instruments, because only options have an exercise date.

BC89 In the context of an employee share option, grant date is when the entity and the employee enter into an agreement, whereby the employee is granted rights to the share option, provided that specified conditions are met, such as the employee's remaining in the entity's employ for a specified period. Service date is the date when the employee renders the services necessary to become entitled to the share option.[†] Vesting date is the date when the employee has satisfied all the conditions necessary to become entitled to the share option. For example, if the employee is required to remain in the entity's employ for three years, vesting date is at the end of that three-year period. Exercise date is when the share option is exercised.

BC90 To help determine the appropriate measurement date, the Board applied the accounting concepts in the *Framework* to each side of the transaction. For transactions with employees, the Board concluded that grant date is the appropriate measurement date, as explained in paragraphs BC91-BC105. The Board also considered some other issues, as explained in paragraphs BC106-BC118. For transactions with parties other than employees, the Board concluded that delivery date is the appropriate measurement date (i.e. the date the goods or services are received, referred to as service date in the context of transactions with employees), as explained in paragraphs BC119-BC128.

---

[*] When the Board developed the proposals in ED 2, it focused on the measurement of equity-settled transactions with employees and with parties other than employees. ED 2 did not propose a definition of the term 'employees'. When the Board reconsidered the proposals in ED 2 in the light of comments received, it discussed whether the term might be interpreted too narrowly. This could result in a different accounting treatment of services received from individuals who are regarded as employees (e.g. for legal or tax purposes) and substantially similar services received from other individuals. The Board therefore concluded that the requirements of the IFRS for transactions with employees should also apply to transactions with other parties providing similar services. This includes services received from (1) individuals who work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes and (2) individuals who are not employees but who render personal services to the entity similar to those rendered by employees. All references to employees therefore includes other parties providing similar services.

[†] Service date measurement theoretically requires the entity to measure the fair value of the share option at each date when services are received. For pragmatic reasons, an approximation would probably be used, such as the fair value of the share option at the end of each accounting period, or the value of the share option measured at regular intervals during each accounting period.

© Copyright

The debit side of the transaction

BC91 Focusing on the debit side of the transaction means focusing on measuring the fair value of the resources received. This measurement objective is consistent with the primary objective of accounting for the goods or services received as consideration for the issue of equity instruments (see paragraphs BC64-BC66). The Board therefore concluded that, in principle, the goods or services received should be measured at their fair value at the date when the entity obtains those goods or as the services are received.

BC92 However, if the fair value of the services received is not readily determinable, then a surrogate measure must be used, such as the fair value of the share options or shares granted. This is the case for employee services.

BC93 If the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, both vesting date and exercise date measurement are inappropriate because the fair value of the services received during a particular accounting period is not affected by subsequent changes in the fair value of the equity instrument. For example, suppose that services are received during years 1-3 as the consideration for share options that are exercised at the end of year 5. For services received in year 1, subsequent changes in the value of the share option in years 2-5 are unrelated to, and have no effect on, the fair value of those services when received.

BC94 Service date measurement measures the fair value of the equity instrument at the same time as the services are received. This means that changes in the fair value of the equity instrument during the vesting period affect the amount attributed to the services received. Some argue that this is appropriate, because, in their view, there is a correlation between changes in the fair value of the equity instrument and the fair value of the services received. For example, they argue that if the fair value of a share option falls, so does its incentive effects, which causes employees to reduce the level of services provided for that option, or demand extra remuneration. Some argue that when the fair value of a share option falls because of a general decline in share prices, remuneration levels also fall, and therefore service date measurement reflects this decline in remuneration levels.

BC95 The Board concluded, however, that there is unlikely to be a high correlation between changes in the fair value of an equity instrument and the fair value of the services received. For example, if the fair value of a share option doubles, it is unlikely that the employees work twice as hard, or accept a reduction in the rest of their remuneration package. Similarly, even if a general rise in share prices is accompanied by a rise in remuneration levels, it is unlikely that there is a high correlation between the two. Furthermore, it is likely that any link between share prices and remuneration levels is not universally applicable to all industry sectors.

BC96 The Board concluded that, at grant date, it is reasonable to presume that the fair value of both sides of the contract are substantially the same, i.e. the fair value of the services expected to be received is substantially the same as the fair value of the equity instruments granted. This conclusion, together with the Board's conclusion that there is unlikely to be a high correlation between the fair value of the services received and the fair value of the equity instruments granted at later measurement dates, led the Board to conclude that grant date is the most appropriate measurement date for the purposes of providing a surrogate measure of the fair value of the services received.

© Copyright

The credit side of the transaction

BC97 Although focusing on the debit side of the transaction is consistent with the primary accounting objective, some approach the measurement date question from the perspective of the credit side of the transaction, i.e. the issue of an equity instrument. The Board therefore considered the matter from this perspective too.

Exercise date

BC98 Under exercise date measurement, the entity recognises the resources received (e.g. employee services) for the issue of share options, and also recognises changes in the fair value of the option until it is exercised or lapses. Thus, if the option is exercised, the transaction amount is ultimately 'trued up' to equal the gain made by the option holder on exercise of the option. However, if the option lapses at the end of the exercise period, any amounts previously recognised are effectively reversed, hence the transaction amount is ultimately trued up to equal zero. The Board rejected exercise date measurement because it requires share options to be treated as liabilities, which is inconsistent with the definition of liabilities in the *Framework*. Exercise date measurement requires share options to be treated as liabilities because it requires the remeasurement of share options after initial recognition, which is inappropriate if the share options are equity instruments. A share option does not meet the definition of a liability, because it does not contain an obligation to transfer cash or other assets.

Vesting date, service date and grant date

BC99 The Board noted that the IASC/G4+1 Discussion Paper supported vesting date measurement, and rejected grant date and service date measurement, because it concluded that the share option is not issued until vesting date. It noted that the employees must perform their side of the arrangement by providing the necessary services and meeting any other performance criteria before the entity is obliged to perform its side of the arrangement. The provision of services by the employees is not merely a condition of the arrangement, it is the consideration they use to 'pay' for the share option. Therefore, the Discussion Paper concluded, in economic terms the share option is not issued until vesting date. Because the entity performs its side of the arrangement on vesting date, that is the appropriate measurement date.

BC100 The Discussion Paper also proposed recognising an accrual in equity during the vesting period to ensure that the services are recognised when they are received. It proposed that this accrual should be revised on vesting date to equal the fair value of the share option at that date. This means that amounts credited to equity during the vesting period will be subsequently remeasured to reflect changes in the value of that equity interest before vesting date. That is inconsistent with the *Framework* because equity interests are not subsequently remeasured, i.e. any changes in their value are not recognised. The Discussion Paper justified this remeasurement by arguing that because the share option is not issued until vesting date, the option is not being remeasured. The credit to equity during the vesting period is merely an interim measure that is used to recognise the partially completed transaction.

BC101 However, the Board noted that even if one accepts that the share option is not issued until vesting date, this does not mean that there is no equity interest until then. If an equity interest exists before vesting date, that interest should not be remeasured. Moreover, the conversion of one type of equity interest into another should not, in itself, cause a change in total equity, because no change in net assets has occurred.

© Copyright

BC102 Some supporters of vesting date suggest that the accrual during the performance period meets the definition of a liability. However, the basis for this conclusion is unclear. The entity is not required to transfer cash or other assets to the employees. Its only commitment is to issue equity instruments.

BC103 The Board concluded that vesting date measurement is inconsistent with the *Framework*, because it requires the remeasurement of equity.

BC104 Service date measurement does not require remeasurement of equity interests after initial recognition. However, as explained earlier, the Board concluded that incorporating changes in the fair value of the share option into the transaction amount is unlikely to produce an amount that fairly reflects the fair value of the services received, which is the primary objective.

BC105 The Board therefore concluded that, no matter which side of the transaction one focuses upon (i.e. the receipt of resources or the issue of an equity instrument), grant date is the appropriate measurement date under the *Framework*, because it does not require remeasurement of equity interests and it provides a reasonable surrogate measure of the fair value of the services received from employees.

Other issues

IAS 32 Financial Instruments: Disclosure and Presentation*

BC106 As discussed above, under the definitions of liabilities and equity in the *Framework*, both shares and share options are equity instruments, because neither instrument requires the entity to transfer cash or other assets. Similarly, all contracts or arrangements that will be settled by the entity issuing shares or share options are classified as equity. However, this differs from the distinction between liabilities and equity applied in IAS 32. Although IAS 32 also considers, in its debt/equity distinction, whether an instrument contains an obligation to transfer cash or other assets, this is supplemented by a second criterion, which considers whether the number of shares to be issued (and cash to be received) on settlement is fixed or variable. IAS 32 classifies a contract that will or may be settled in the entity's own equity instruments as a liability if the contract is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

BC107 In some cases, the number of share options to which employees are entitled varies. For example, the number of share options to which the employees will be entitled on vesting date might vary depending on whether, and to the extent that, a particular performance target is exceeded. Another example is share appreciation rights settled in shares. In this situation, a variable number of shares will be issued, equal in value to the appreciation of the entity's share price over a period of time.

BC108 Therefore, if the requirements of IAS 32 were applied to equity-settled share-based payment transactions, in some situations an obligation to issue equity instruments would be classified as a liability. In such cases, final measurement of the transaction would be at a measurement date later than grant date.

* In August 2005 IAS was amended as IAS 32 *Financial Instruments: Presentation*.

© Copyright

BC109 The Board concluded that different considerations applied in developing IFRS 2. For example, drawing a distinction between fixed and variable option plans and requiring a later measurement date for variable option plans has undesirable consequences, as discussed in paragraphs BC272-BC275.

BC110 The Board concluded that the requirements in IAS 32, whereby some obligations to issue equity instruments are classified as liabilities, should not be applied in the IFRS on share-based payment. The Board recognises that this creates a difference between IFRS 2 and IAS 32. Before deciding whether and how that difference should be eliminated, the Board concluded that it is necessary to address this issue in a broader context, as part of a fundamental review of the definitions of liabilities and equity in the *Framework*, particularly because this is not the only debt/ equity classification issue that has arisen in the share-based payment project, as explained below.

Suggestions to change the definitions of liabilities and equity

BC111 In concluding that, for transactions with employees, grant date is the appropriate measurement date under the *Framework*, the Board noted that some respondents to ED 2 and the Discussion Paper support other measurement dates because they believe that the definitions of liabilities and equity in the *Framework* should be revised.

BC112 For example, some supporters of vesting date argue that receipt of employee services between grant date and vesting date creates an obligation for the entity to pay for those services, and that the method of settlement should not matter. In other words, it should not matter whether that obligation is settled in cash or in equity instruments—both ought to be treated as liabilities. Therefore, the definition of a liability should be modified so that all types of obligations, however settled, are included in liabilities. But it is not clear that this approach would necessarily result in vesting date measurement. A share option contains an obligation to issue shares. Hence, if all types of obligations are classified as liabilities, then a share option would be a liability, which would result in exercise date measurement.

BC113 Some support exercise date measurement on the grounds that it produces the same accounting result as 'economically similar' cash-settled share-based payments. For example, it is argued that share appreciation rights (SARs) settled in cash are substantially similar to SARs settled in shares, because in both cases the employee receives consideration to the same value. Also, if the SARs are settled in shares and the shares are immediately sold, the employee ends up in exactly the same position as under a cash-settled SAR, i.e. with cash equal to the appreciation in the entity's share price over the specified period. Similarly, some argue that share options and cash-settled SARs are economically similar. This is particularly true when the employee realises the gain on the exercise of share options by selling the shares immediately after exercise, as commonly occurs. Either way, the employee ends up with an amount of cash that is based on the appreciation of the share price over a period of time. If cash-settled transactions and equity-settled transactions are economically similar, the accounting treatment should be the same.

BC114 However, it is not clear that changing the distinction between liabilities and equity to be consistent with exercise date measurement is the only way to achieve the same accounting treatment. For example, the distinction could be changed so that cash-settled employee share plans are measured at grant date, with the subsequent cash payment debited directly to equity, as a distribution to equity participants.

BC115 Others who support exercise date measurement do not regard share option holders as part of the ownership group, and therefore believe that options should not be classified as equity. Option holders, some argue, are only potential owners of the entity. But it is not clear whether this view is held generally, i.e. applied to all types of options. For example, some who support exercise date measurement for employee share options do not necessarily advocate the same approach for share options or warrants issued for cash in the market. However, any revision to the definitions of liabilities and equity in the *Framework* would affect the classification of all options and warrants issued by the entity.

BC116 Given that there is more than one suggestion to change the definitions of liabilities and equity, and these suggestions have not been fully explored, it is not clear exactly what changes to the definitions are being proposed.

BC117 Moreover, the Board concluded that these suggestions should not be considered in isolation, because changing the distinction between liabilities and equity affects all sorts of financial interests, not just those relating to employee share plans. All of the implications of any suggested changes should be explored in a broader project to review the definitions of liabilities and equity in the *Framework*. If such a review resulted in changes to the definitions, the Board would then consider whether the IFRS on share-based payment should be revised.

BC118 Therefore, after considering the issues discussed above, the Board confirmed its conclusion that grant date is the appropriate date at which to measure the fair value of the equity instruments granted for the purposes of providing a surrogate measure of the fair value of services received from employees.

Share-based payment transactions with parties other than employees

BC119 In many share-based payment transactions with parties other than employees, it should be possible to measure reliably the fair value of the goods or services received. The Board therefore concluded that the IFRS should require an entity to presume that the fair value of the goods or services received can be measured reliably.* However, in rare cases in which the presumption is rebutted, it is necessary to measure the transaction at the fair value of the equity instruments granted.

BC120 Some measurement issues that arise in respect of share-based payment transactions with employees also arise in transactions with other parties. For example, there might be performance (i.e. vesting) conditions that must be met before the other party is entitled to the shares or share options. Therefore, any conclusions reached on how to treat vesting conditions in the context of share-based payment transactions with employees also apply to transactions with other parties.

---

* ED 2 proposed that equity-settled share-based payment transactions should be measured at the fair value of the goods or services received, or by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable. For transactions with parties other than employees, ED 2 proposed that there should be a rebuttable presumption that the fair value of the goods or services received is the more readily determinable fair value. The Board reconsidered these proposed requirements when finalising the IFRS. It concluded that it would be more consistent with the primary accounting objective (explained in paragraphs BC64-BC66) to require equity-settled share-based payment transactions to be measured at the fair value of the goods or services received, unless that fair value cannot be estimated reliably (e.g. in transactions with employees). For transactions with parties other than employees, the Board concluded that, in many cases, it should be possible to measure reliably the fair value of the goods or services received, as noted above. Hence, the Board concluded that the IFRS should require an entity to presume that the fair value of the goods or services received can be measured reliably.

BC121 Similarly, performance by the other party might take place over a period of time, rather than on one specific date, which again raises the question of the appropriate measurement date.

BC122 SFAS 123 does not specify a measurement date for share-based payment transactions with parties other than employees, on the grounds that this is usually a minor issue in such transactions. However, the date at which to estimate the fair value of equity instruments issued to parties other than employees is specified in the US interpretation EITF 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*:

> [The measurement date is] the earlier of the following:
>
> 1. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a "performance commitment"), or
>
> 2. The date at which the counterparty's performance is complete. (extract from Issue 1, footnotes excluded)

BC123 The second of these two dates corresponds to vesting date, because vesting date is when the other party has satisfied all the conditions necessary to become unconditionally entitled to the share options or shares. The first of the two dates does not necessarily correspond to grant date. For example, under an employee share plan, the employees are (usually) not committed to providing the necessary services, because they are usually able to leave at any time. Indeed, EITF 96-18 makes it clear that the fact that the equity instrument will be forfeited if the counterparty fails to perform is not sufficient evidence of a performance commitment (Issue 1, footnote 3). Therefore, in the context of share-based payment transactions with parties other than employees, if the other party is not committed to perform, there would be no performance commitment date, in which case the measurement date would be vesting date.

BC124 Accordingly, under SFAS 123 and EITF 96-18, the measurement date for share-based payment transactions with employees is grant date, but for transactions with other parties the measurement date could be vesting date, or some other date between grant date and vesting date.

BC125 In developing the proposals in ED 2, the Board concluded that for transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted, the equity instruments should be measured at grant date, the same as for transactions with employees.

BC126 However, the Board reconsidered this conclusion during its redeliberations of the proposals in ED 2. The Board considered whether the delivery (service) date fair value of the equity instruments granted provided a better surrogate measure of the fair value of the goods or services received from parties other than employees than the grant date fair value of those instruments. For example, some argue that if the counterparty is not firmly committed to delivering the goods or services, the counterparty would consider whether the fair value of the equity instruments at the delivery date is sufficient payment for the goods or services when deciding whether to deliver the goods or services. This suggests that there is a high correlation between the fair value of the equity instruments at the date the goods or services are received and the fair value of those goods or services. The Board noted that it had considered and rejected a similar argument in the context of transactions with employees (see paragraphs BC94 and BC95). However, the Board found the argument more compelling in the case of

transactions with parties other than employees, particularly for transactions in which the counterparty delivers the goods or services on a single date (or over a short period of time) that is substantially later than grant date, compared with transactions with employees in which the services are received over a continuous period that typically begins on grant date.

BC127 The Board was also concerned that permitting entities to measure transactions with parties other than employees on the basis of the fair value of the equity instruments at grant date would provide opportunities for entities to structure transactions to achieve a particular accounting result, causing the carrying amount of the goods or services received, and the resulting expense for the consumption of those goods or services, to be understated.

BC128 The Board therefore concluded that for transactions with parties other than employees in which the entity cannot measure reliably the fair value of the goods or services received at the date of receipt, the fair value of those goods or services should be measured indirectly, based on the fair value of the equity instruments granted, measured at the date the goods or services are received.

Transactions in which the entity cannot identify specifically some or all of the goods or services received (paragraph 13A)*

BC128A The Board incorporated into IFRS 2 the consensus of IFRIC 8 in *Group Cash-settled Share-based Payment Transactions* issued in June 2009. This section summarises the IFRIC's considerations in reaching that consensus, as approved by the Board.

BC128B IFRS 2 presumes that the consideration received for share-based payments is consistent with the fair value of those share-based payments. For example, if the entity cannot estimate reliably the fair value of the goods or services received, paragraph 10 of the IFRS requires the entity to measure the fair value of the goods or services received by reference to the fair value of the share-based payment made to acquire those goods or services.

BC128C The Board noted that it is neither necessary nor appropriate to measure the fair value of goods or services as well as the fair value of the share-based payment for every transaction in which the entity receives goods or non-employee services. However, when the value of the identifiable consideration received appears to be less than the fair value of the share-based payment, measurement of both the goods or the services received and the share-based payment may be necessary in order to measure the value of the unidentifiable goods or services received.

BC128D Paragraph 13 of the IFRS stipulates a rebuttable presumption that the value of identifiable goods or services received can be reliably measured. The Board noted that goods or services that are unidentifiable cannot be reliably measured and that this rebuttable presumption is relevant only for identifiable goods or services.

BC128E The Board noted that when the goods or services received are identifiable, the measurement principles in the IFRS should be applied. When the goods or services received are unidentifiable, the Board concluded that the grant date is the most appropriate date for the purposes of providing a surrogate measure of the value of the unidentifiable goods or services received (or to be received).

* Paragraphs BC128A–BC128H are added as a consequence of amendments to IFRS 2 *Group Cash-settled Share-based Payment Transactions* issued in June 2009.

BC128F The Board noted that some transactions include identifiable and unidentifiable goods or services. In this case, it would be necessary to measure at the grant date the fair value of the unidentifiable goods or services received and to measure the value of the identifiable goods or services in accordance with the IFRS.

BC128G For cash-settled transactions in which unidentifiable goods or services are received, it is necessary to remeasure the liability at each subsequent reporting date in order to be consistent with the IFRS.

BC128H The Board noted that the IFRS's requirements in respect of the recognition of the expense arising from share-based payments would apply to identifiable and unidentifiable goods or services. Therefore, the Board decided not to issue additional guidance on this point.

Fair value of employee share options

BC129 The Board spent much time discussing how to measure the fair value of employee share options, including how to take into account common features of employee share options, such as vesting conditions and non-transferability. These discussions focused on measuring fair value at grant date, not only because the Board regarded grant date as the appropriate measurement date for transactions with employees, but also because more measurement issues arise at grant date than at later measurement dates. In reaching its conclusions in ED 2, the Board received assistance from the project's Advisory Group and from a panel of experts. During its redeliberations of the proposals in ED 2, the Board considered comments by respondents and advice received from valuation experts on the FASB's Option Valuation Group.

BC130 Market prices provide the best evidence of the fair value of share options. However, share options with terms and conditions similar to employee share options are seldom traded in the markets. The Board therefore concluded that, if market prices are not available, it will be necessary to apply an option pricing model to estimate the fair value of share options.

BC131 The Board decided that it is not necessary or appropriate to prescribe the precise formula or model to be used for option valuation. There is no particular option pricing model that is regarded as theoretically superior to the others, and there is the risk that any model specified might be superseded by improved methodologies in the future. Entities should select whichever model is most appropriate in the circumstances. For example, many employee share options have long lives, are usually exercisable during the period between vesting date and the end of the option's life, and are often exercised early. These factors should be considered when estimating the grant date fair value of share options. For many entities, this might preclude the use of the Black-Scholes-Merton formula, which does not take into account the possibility of exercise before the end of the share option's life and may not adequately reflect the effects of expected early exercise. This is discussed further below (paragraphs BC160-BC162).

© Copyright

BC132 All option pricing models take into account the following option features:

- the exercise price of the option
- the current market price of the share
- the expected volatility of the share price
- the dividends expected to be paid on the shares
- the rate of interest available in the market
- the term of the option.

BC133 The first two items define the intrinsic value of a share option; the remaining four are relevant to the share option's time value. Expected volatility, dividends and interest rate are all based on expectations over the option term. Therefore, the option term is an important part of calculating time value, because it affects the other inputs.

BC134 One aspect of time value is the value of the right to participate in future gains, if any. The valuation does not attempt to predict what the future gain will be, only the amount that a buyer would pay at the valuation date to obtain the right to participate in any future gains. In other words, option pricing models estimate the value of the share option at the measurement date, not the value of the underlying share at some future date.

BC135 The Board noted that some argue that any estimate of the fair value of a share option is inherently uncertain, because it is not known what the ultimate outcome will be, eg whether the share option will expire worthless or whether the employee (or other party) will make a large gain on exercise. However, the valuation objective is to measure the fair value of the rights granted, not to predict the outcome of having granted those rights. Hence, irrespective of whether the option expires worthless or the employee makes a large gain on exercise, that outcome does not mean that the grant date estimate of the fair value of the option was unreliable or wrong.

BC136 A similar analysis applies to the argument that share options do not have any value until they are in the money, ie the share price is greater than the exercise price. This argument refers to the share option's intrinsic value only. Share options also have a time value, which is why they are traded in the markets at prices greater than their intrinsic value. The option holder has a valuable right to participate in any future increases in the share price. So even share options that are at the money have a value when granted. The subsequent outcome of that option grant, even if it expires worthless, does not change the fact that the share option had a value at grant date.

Application of option pricing models to unlisted and newly listed entities

BC137 As explained above, two of the inputs to an option pricing model are the entity's share price and the expected volatility of its share price. For an unlisted entity, there is no published share price information. The entity would therefore need to estimate the fair value of its shares (e.g. based on the share price of similar entities that are listed, or on a net assets or earnings basis). It would also need to estimate the expected volatility of that value.

BC138 The Board considered whether unlisted entities should be permitted to use the minimum value method instead of a fair value measurement method. The minimum value method is explained earlier, in paragraphs BC80-BC83. Because it excludes the effects of expected volatility, the minimum value method produces a value that is lower, often much lower, than that produced by methods designed to estimate the fair value of an option. Therefore, the Board discussed how an unlisted entity could estimate expected volatility.

BC139 An unlisted entity that regularly issues share options or shares to employees (or other parties) might have an internal market for its shares. The volatility of the internal market share prices provides a basis for estimating expected volatility. Alternatively, an entity could use the historical or implied volatility of similar entities that are listed, and for which share price or option price information is available, as the basis for an estimate of expected volatility. This would be appropriate if the entity has estimated the value of its shares by reference to the share prices of these similar listed entities. If the entity has instead used another methodology to value its shares, the entity could derive an estimate of expected volatility consistent with that methodology. For example, the entity might value its shares on the basis of net asset values or earnings, in which case it could use the expected volatility of those net asset values or earnings as a basis for estimating expected share price volatility.

BC140 The Board acknowledged that these approaches for estimating the expected volatility of an unlisted entity's shares are somewhat subjective. However, the Board thought it likely that, in practice, the application of these approaches would result in underestimates of expected volatility, rather than overestimates, because entities were likely to exercise caution in making such estimates, to ensure that the resulting option values are not overstated. Therefore, estimating expected volatility is likely to produce a more reliable measure of the fair value of share options granted by unlisted entities than an alternative valuation method, such as the minimum value method.

BC141 Newly listed entities would not need to estimate their share price. However, like unlisted entities, newly listed entities could have difficulties in estimating expected volatility when valuing share options, because they might not have sufficient historical share price information upon which to base an estimate of expected volatility.

BC142 SFAS 123 requires such entities to consider the historical volatility of similar entities during a comparable period in their lives:

> For example, an entity that has been publicly traded for only one year that grants options with an average expected life of five years might consider the pattern and level of historical volatility of more mature entities in the same industry for the first six years the stock of those entities were publicly traded. (paragraph 285b)

BC143 The Board concluded that, in general, unlisted and newly listed entities should not be exempt from a requirement to apply fair value measurement and that the IFRS should include implementation guidance on estimating expected volatility for the purposes of applying an option pricing model to share options granted by unlisted and newly listed entities.

BC144 However, the Board acknowledged that there might be some instances in which an entity—such as (but not limited to) an unlisted or newly listed entity—cannot estimate reliably the grant date fair value of share options granted. In this situation, the Board concluded that the entity should measure the share option at its intrinsic value, initially at the date the entity obtains the goods or the counterparty renders service and subsequently at each reporting date until the final settlement of the share-based

© Copyright

payment arrangement, with the effects of the remeasurement recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, forfeited (eg upon cessation of employment) or lapse (eg at the end of the option's life). For a grant of shares, the share-based payment arrangement is finally settled when the shares vest or are forfeited.

Application of option pricing models to employee share options

BC145 Option pricing models are widely used in, and accepted by, the financial markets. However, there are differences between employee share options and traded share options. The Board considered the valuation implications of these differences, with assistance from its Advisory Group and other experts, including experts in the FASB's Option Valuation Group, and comments made by respondents to ED 2. Employee share options usually differ from traded options in the following ways, which are discussed further below:

(a) there is a vesting period, during which time the share options are not exercisable;

(b) the options are non-transferable;

(c) there are conditions attached to vesting which, if not satisfied, cause the options to be forfeited; and

(d) the option term is significantly longer.

Inability to exercise during the vesting period

BC146 Typically, employee share options have a vesting period, during which the options cannot be exercised. For example, a share option might be granted with a ten-year life and a vesting period of three years, so the option is not exercisable for the first three years and can then be exercised at any time during the remaining seven years. Employee share options cannot be exercised during the vesting period because the employees must first 'pay' for the options, by providing the necessary services. Furthermore, there might be other specified periods during which an employee share option cannot be exercised (eg during a closed period).

BC147 In the finance literature, employee share options are sometimes called Bermudian options, being partly European and partly American. An American share option can be exercised at any time during the option's life, whereas a European share option can be exercised only at the end of the option's life. An American share option is more valuable than a European share option, although the difference in value is not usually significant.

BC148 Therefore, other things being equal, an employee share option would have a higher value than a European share option and a lower value than an American share option, but the difference between the three values is unlikely to be significant.

BC149 If the entity uses the Black-Scholes-Merton formula, or another option pricing model that values European share options, there is no need to adjust the model for the inability to exercise an option in the vesting period (or any other period), because the model already assumes that the option cannot be exercised during that period.

© Copyright

BC150 If the entity uses an option pricing model that values American share options, such as the binomial model, the inability to exercise an option during the vesting period can be taken into account in applying such a model.

BC151 Although the inability to exercise the share option during the vesting period does not, in itself, have a significant effect on the value of the option, there is still the question whether this restriction has an effect when combined with non-transferability. This is discussed in the following section.

BC152 The Board therefore concluded that:

(a) if the entity uses an option pricing model that values European share options, such as the Black-Scholes-Merton formula, no adjustment is required for the inability to exercise the options during the vesting period, because the model already assumes that they cannot be exercised during that period.

(b) if the entity uses an option pricing model that values American share options, such as a binomial model, the application of the model should take account of the inability to exercise the options during the vesting period.

Non-transferability

BC153 From the option holder's perspective, the inability to transfer a share option limits the opportunities available when the option has some time yet to run and the holder wishes either to terminate the exposure to future price changes or to liquidate the position. For example, the holder might believe that over the remaining term of the share option the share price is more likely to decrease than to increase. Also, employee share option plans typically require employees to exercise vested options within a fixed period of time after the employee leaves the entity, or to forfeit the options.

BC154 In the case of a conventional share option, the holder would sell the option rather than exercise it and then sell the shares. Selling the share option enables the holder to receive the option's fair value, including both its intrinsic value and remaining time value, whereas exercising the option enables the holder to receive intrinsic value only.

BC155 However, the option holder is not able to sell a non-transferable share option. Usually, the only possibility open to the option holder is to exercise it, which entails forgoing the remaining time value. (This is not always true. The use of other derivatives, in effect, to sell or gain protection from future changes in the value of the option is discussed later.)

BC156 At first sight, the inability to transfer a share option could seem irrelevant from the entity's perspective, because the entity must issue shares at the exercise price upon exercise of the option, no matter who holds it. In other words, from the entity's perspective, its commitments under the contract are unaffected by whether the shares are issued to the original option holder or to someone else. Therefore, in valuing the entity's side of the contract, from the entity's perspective, non-transferability seems irrelevant.

BC157 However, the lack of transferability often results in early exercise of the share option, because that is the only way for the employees to liquidate their position. Therefore, by imposing the restriction on transferability, the entity has caused the option holder to exercise the option early, thereby resulting in the loss of time value. For example, one aspect of time value is the value of the right to defer payment of the exercise price until the end of the option term. If the option is exercised early because of non-transferability, the entity receives the exercise price much earlier than it would otherwise have done.

© Copyright

BC158 Non-transferability is not the only reason why employees might exercise share options early. Other reasons include risk aversion, lack of wealth diversification, and termination of employment (typically, employees must exercise vested options soon after termination of employment; otherwise the options are forfeited).

BC159 Recent accounting standards and proposed standards (including ED 2) address the issue of early exercise by requiring the expected life of a non-transferable share option to be used in valuing it, rather than the contractual option term. Expected life can be estimated either for the entire share option plan or for subgroups of employees participating in the plan. The estimate takes into account factors such as the length of the vesting period, the average length of time similar options have remained outstanding in the past and the expected volatility of the underlying shares.

BC160 However, comments from respondents to ED 2 and advice received from valuation experts during the Board's redeliberations led the Board to conclude that using a single expected life as an input into an option pricing model (eg the Black-Scholes-Merton formula) was not the best solution for reflecting in the share option valuation the effects of early exercise. For example, such an approach does not take into account the correlation between the share price and early exercise. It would also mean that the share option valuation does not take into account the possibility that the option might be exercised at a date that is later than the end of its expected life. Therefore, in many instances, a more flexible model, such as a binomial model, that uses the share option's contractual life as an input and takes into account the possibility of early exercise on a range of different dates in the option's life, allowing for factors such as the correlation between the share price and early exercise and expected employee turnover, is likely to produce a more accurate estimate of the option's fair value.

BC161 Binomial lattice and similar option pricing models also have the advantage of permitting the inputs to the model to vary over the share option's life. For example, instead of using a single expected volatility, a binomial lattice or similar option pricing model can allow for the possibility that volatility might change over the share option's life. This would be particularly appropriate when valuing share options granted by entities experiencing higher than usual volatility, because volatility tends to revert to its mean over time.

BC162 For these reasons, the Board considered whether it should require the use of a more flexible model, rather than the more commonly used Black-Scholes-Merton formula. However, the Board concluded that it was not necessary to prohibit the use of the Black-Scholes-Merton formula, because there might be instances in which the formula produces a sufficiently reliable estimate of the fair value of the share options granted. For example, if the entity has not granted many share options, the effects of applying a more flexible model might not have a material impact on the entity's financial statements. Also, for share options with relatively short contractual lives, or share options that must be exercised within a short period of time after vesting date, the issues discussed in paragraph BC160 may not be relevant, and hence the Black-Scholes-Merton formula may produce a value that is substantially the same as that produced by a more flexible option pricing model. Therefore, rather than prohibit the use of the Black-Scholes-Merton formula, the Board concluded that the IFRS should include guidance on selecting the most appropriate model to apply. This includes the requirement that the entity should consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply.

© Copyright

BC163 Although non-transferability often results in the early exercise of employee share options, some employees can mitigate the effects of non-transferability, because they are able, in effect, to sell the options or protect themselves from future changes in the value of the options by selling or buying other derivatives. For example, the employee might be able, in effect, to sell an employee share option by entering into an arrangement with an investment bank whereby the employee sells a similar call option to the bank, i.e. an option with the same exercise price and term. A zero-cost collar is one means of obtaining protection from changes in the value of an employee share option, by selling a call option and buying a put option.

BC164 However, it appears that such arrangements are not always available. For example, the amounts involved have to be sufficiently large to make it worthwhile for the investment bank, which would probably exclude many employees (unless a collective arrangement was made). Also, it appears that investment banks are unlikely to enter into such an arrangement unless the entity is a top listed company, with shares traded in a deep and active market, to enable the investment bank to hedge its own position.

BC165 It would not be feasible to stipulate in an accounting standard that an adjustment to take account of non-transferability is necessary only if the employees cannot mitigate the effects of non-transferability through the use of other derivatives. However, using expected life as an input into an option pricing model, or modelling early exercise in a binomial or similar model, copes with both situations. If employees were able to mitigate the effects of non-transferability by using derivatives, this would often result in the employee share options being exercised later than they would otherwise have been. By taking this factor into account, the estimated fair value of the share option would be higher, which makes sense, given that non-transferability is not a constraint in this case. If the employees cannot mitigate the effects of non-transferability through the use of derivatives, they are likely to exercise the share options much earlier than is optimal. In this case, allowing for the effects of early exercise would significantly reduce the estimated value of the share option.

BC166 This still leaves the question whether there is a need for further adjustment for the combined effect of being unable to exercise or transfer the share option during the vesting period. In other words, the inability to exercise a share option does not, in itself, appear to have a significant effect on its value. But if the share option cannot be transferred and cannot be exercised, and assuming that other derivatives are not available, the holder is unable to extract value from the share option or protect its value during the vesting period.

BC167 However, it should be noted why these restrictions are in place: the employee has not yet ‘paid’ for the share option by providing the required services (and fulfilling any other performance conditions). The employee cannot exercise or transfer a share option to which he/she is not yet entitled. The share option will either vest or fail to vest, depending on whether the vesting conditions are satisfied. The possibility of forfeiture resulting from failure to fulfil the vesting conditions is taken into account through the application of the modified grant date method (discussed in paragraphs BC170-BC184).

BC168 Moreover, for accounting purposes, the objective is to estimate the fair value of the share option, not the value from the employee’s perspective. The fair value of any item depends on the expected amounts, timing, and uncertainty of the future cash flows relating to the item. The share option grant gives the employee the right to subscribe to the entity’s shares at the exercise price, provided that the vesting conditions are satisfied and the exercise price is paid during the specified period. The effect of the vesting conditions is considered below. The effect of the share option being

© Copyright

non-exercisable during the vesting period has already been considered above, as has the effect of non-transferability. There does not seem to be any additional effect on the expected amounts, timing or uncertainty of the future cash flows arising from the combination of non-exercisability and non-transferability during the vesting period.

BC169 After considering all of the above points, the Board concluded that the effects of early exercise, because of non-transferability and other factors, should be taken into account when estimating the fair value of the share option, either by modelling early exercise in a binomial or similar model, or using expected life rather than contracted life as an input into an option pricing model, such as the Black-Scholes-Merton formula.

Vesting conditions

BC170 Employee share options usually have vesting conditions. The most common condition is that the employee must remain in the entity's employ for a specified period, say three years. If the employee leaves during that period, the options are forfeited. There might also be other performance conditions, eg that the entity achieves a specified growth in share price or earnings.

BC171 Vesting conditions ensure that the employees provide the services required to 'pay' for their share options. For example, the usual reason for imposing service conditions is to retain staff; the usual reason for imposing other performance conditions is to provide an incentive for the employees to work towards specified performance targets.

BC171A In 2005 the Board decided to take on a project to clarify the definition of vesting conditions and the accounting treatment of cancellations. In particular, the Board noted that it is important to distinguish between non-vesting conditions, which need to be satisfied for the counterparty to become entitled to the equity instrument, and vesting conditions such as performance conditions. In February 2006 the Board published an exposure draft *Vesting Conditions and Cancellations*, which proposed to restrict vesting conditions to service conditions and performance conditions. Those are the only conditions that determine whether *the entity receives the services* that entitle the counterparty to the share-based payment, and therefore whether the share-based payment vests. In particular, a share-based payment may vest even if some non-vesting conditions have not been met. The feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or implicit service requirement and the latter does not.

BC171B In general, respondents to the exposure draft agreed with the Board's proposals but asked for clarification of whether particular restrictive conditions, such as 'non-compete provisions', are vesting conditions. The Board noted that a share-based payment vests when the counterparty's entitlement to it is no longer conditional on future service or performance conditions. Therefore, conditions such as non-compete provisions and transfer restrictions, which apply after the counterparty has become entitled to the share-based payment, are not vesting conditions. The Board revised the definition of 'vest' accordingly.

BC172 Some argue that the existence of vesting conditions does not necessarily imply that the value of employee share options is significantly less than the value of traded share options. The employees have to satisfy the vesting conditions to fulfil their side of the arrangement. In other words, the employees' performance of their side of the arrangement is what they do to pay for their share options. Employees do not pay for the options with cash, as do the holders of traded share options; they pay with their services. Having to pay for the share options does not make them less valuable. On the contrary, it proves that the share options are valuable.

BC173 Others argue that the possibility of forfeiture without compensation for part-performance suggests that the share options are less valuable. The employees might partly perform their side of the arrangement, e.g. by working for part of the period, then have to leave for some reason, and forfeit the share options without compensation for that part performance. If there are other performance conditions, such as achieving a specified growth in the share price or earnings, the employees might work for the entire vesting period, but fail to meet the vesting conditions and therefore forfeit the share options.

BC174 Similarly, some argue that the entity would take into account the possibility of forfeiture when entering into the agreement at grant date. In other words, in deciding how many share options to grant in total, the entity would allow for expected forfeitures. Hence, if the objective is to estimate at grant date the fair value of the entity's commitments under the share option agreement, that valuation should take into account that the entity's commitment to fulfil its side of the option agreement is conditional upon the vesting conditions being satisfied.

BC175 In developing the proposals in ED 2, the Board concluded that the valuation of rights to share options or shares granted to employees (or other parties) should take into account all types of vesting conditions, including both service conditions and performance conditions. In other words, the grant date valuation should be reduced to allow for the possibility of forfeiture due to failure to satisfy the vesting conditions.

BC176 Such a reduction might be achieved by adapting an option pricing model to incorporate vesting conditions. Alternatively, a more simplistic approach might be applied. One such approach is to estimate the possibility of forfeiture at grant date, and reduce the value produced by an option pricing model accordingly. For example, if the valuation calculated using an option pricing model was CU15, and the entity estimated that 20 per cent of the share options would be forfeited because of failure to satisfy the vesting conditions, allowing for the possibility of forfeiture would reduce the grant date value of each option granted from CU15 to CU12.

BC177 The Board decided against proposing detailed guidance on how the grant date value should be adjusted to allow for the possibility of forfeiture. This is consistent with the Board's objective of setting principles-based standards. The measurement objective is to estimate fair value. That objective might not be achieved if detailed, prescriptive rules were specified, which would probably become outdated by future developments in valuation methodologies.

BC178 However, respondents to ED 2 raised a variety of concerns about the inclusion of vesting conditions in the grant date valuation. Some respondents were concerned about the practicality and subjectivity of including non-market performance conditions in the share option valuation. Some were also concerned about the practicality of including service conditions in the grant date valuation, particularly in conjunction with the units of service method proposed in ED 2 (discussed further in paragraphs BC203-BC217).

BC179 Some respondents suggested the alternative approach applied in SFAS 123, referred to as the modified grant date method. Under this method, service conditions and non-market performance conditions are excluded from the grant date valuation (i.e. the possibility of forfeiture is not taken into account when estimating the grant date fair value of the share options or other equity instruments, thereby producing a higher grant date fair value), but are instead taken into account by requiring the transaction amount to be based on the number of equity instruments that eventually vest. Under this method, 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), e.g. the counterparty fails to complete a specified service period, or a performance condition (other than a market condition) is not satisfied.

BC180 After considering respondents' comments and obtaining further advice from valuation experts, the Board decided to adopt the modified grant date method applied in SFAS 123. However, the Board decided that it should not permit the choice available in SFAS 123 to account for the effects of expected or actual forfeitures of share options or other equity instruments because of failure to satisfy a service condition. For a grant of equity instruments with a service condition, SFAS 123 permits an entity to choose at grant date to recognise the services received based on an estimate of the number of share options or other equity instruments expected to vest, and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from previous estimates. Alternatively, an entity may begin recognising the services received as if all the equity instruments granted that are subject to a service requirement are expected to vest. The effects of forfeitures are then recognised when those forfeitures occur, by reversing any amounts previously recognised for services received as consideration for equity instruments that are forfeited.

BC181 The Board decided that the latter method should not be permitted. Given that the transaction amount is ultimately based on the number of equity instruments that vest, it is appropriate to estimate the number of expected forfeitures when recognising the services received during the vesting period. Furthermore, by ignoring expected forfeitures until those forfeitures occur, the effects of reversing any amounts previously recognised might result in a distortion of remuneration expense recognised during the vesting period. For example, an entity that experiences a high level of forfeitures might recognise a large amount of remuneration expense in one period, which is then reversed in a later period.

BC182 Therefore, the Board decided that the IFRS should require an entity to estimate the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from previous estimates.

BC183 Under SFAS 123, market conditions (eg a condition involving a target share price, or specified amount of intrinsic value on which vesting or exercisability is conditioned) are included in the grant date valuation, without subsequent reversal. That is to say, when estimating the fair value of the equity instruments at grant date, the entity takes into account the possibility that the market condition may not be satisfied. Having allowed for that possibility in the grant date valuation of the equity instruments, no adjustment is made to the number of equity instruments included in the calculation of the transaction amount, irrespective of the outcome of the market condition. In other words, the entity recognises the goods or services received from a counterparty that satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied. The treatment of market conditions therefore contrasts with the treatment of other types of vesting conditions. As explained in paragraph BC179, under the modified grant date method, vesting conditions are not taken into account when estimating the fair value of the equity instruments at grant date, but are instead taken into account by requiring the transaction amount to be based on the number of equity instruments that eventually vest.

BC184 The Board considered whether it should apply the same approach to market conditions as is applied in SFAS 123. It might be argued that it is not appropriate to distinguish between market conditions and other types of performance conditions, because to do so could create opportunities for arbitrage, or cause an economic distortion by encouraging entities to favour one type of performance condition over another. However, the Board noted that it is not clear what the result would be. On the one hand, some entities might prefer the 'truing up' aspect of the modified grant date method, because it permits a reversal of remuneration expense if the condition is not met. On the other hand, if the performance condition is met, and it has not been incorporated into the grant date valuation (as is the case when the modified grant date method is used), the expense will be higher than it would otherwise have been (i.e. if the performance condition had been incorporated into the grant date valuation). Furthermore, some entities might prefer to avoid the potential volatility caused by the truing up mechanism. Therefore, it is not clear whether having a different treatment for market and non-market performance conditions will necessarily cause entities to favour market conditions over non-market performance conditions, or vice versa. Furthermore, the practical difficulties that led the Board to conclude that non-market performance conditions should be dealt with via the modified grant date method rather than being included in the grant date valuation do not apply to market conditions, because market conditions can be incorporated into option pricing models. Moreover, it is difficult to distinguish between market conditions, such as a target share price, and the market condition that is inherent in the option itself, i.e. that the option will be exercised only if the share price on the date of exercise exceeds the exercise price. For these reasons, the Board concluded that the IFRS should apply the same approach as is applied in SFAS 123.

Option term

BC185 Employee share options often have a long contractual life, e.g. ten years. Traded options typically have short lives, often only a few months. Estimating the inputs required by an option pricing model, such as expected volatility, over long periods can be difficult, giving rise to the possibility of significant estimation error. This is not usually a problem with traded share options, given their much shorter lives.

BC186 However, some share options traded over the counter have long lives, such as ten or fifteen years. Option pricing models are used to value them. Therefore, contrary to the argument sometimes advanced, option pricing models can be (and are being) applied to long-lived share options.

BC187 Moreover, the potential for estimation error is mitigated by using a binomial or similar model that allows for changes in model inputs over the share option's life, such as expected volatility, and interest and dividend rates, that could occur and the probability of those changes occurring during the term of the share option. The potential for estimation error is further mitigated by taking into account the possibility of early exercise, either by using expected life rather than contracted life as an input into an option pricing model or by modelling exercise behaviour in a binomial or similar model, because this reduces the expected term of the share option. Because employees often exercise their share options relatively early in the share option's life, the expected term is usually much shorter than contracted life.

Other features of employee share options

BC188 Whilst the features discussed above are common to most employee share options, some might include other features. For example, some share options have a reload feature. This entitles the employee to automatic grants of additional share options whenever he/she exercises previously granted share options and pays the exercise price in the

entity's shares rather than in cash. Typically, the employee is granted a new share option, called a reload option, for each share surrendered when exercising the previous share option. The exercise price of the reload option is usually set at the market price of the shares on the date the reload option is granted.

BC189 When SFAS 123 was developed, the FASB concluded that, ideally, the value of the reload feature should be included in the valuation of the original share option at grant date. However, at that time the FASB believed that it was not possible to do so. Accordingly, SFAS 123 does not require the reload feature to be included in the grant date valuation of the original share option. Instead, reload options granted upon exercise of the original share options are accounted for as a new share option grant.

BC190 However, recent academic research indicates that it is possible to value the reload feature at grant date, e.g. Saly, Jagannathan and Huddart (1999).* However, if significant uncertainties exist, such as the number and timing of expected grants of reload options, it might not be practicable to include the reload feature in the grant date valuation.

BC191 When it developed ED 2, the Board concluded that the reload feature should be taken into account, where practicable, when measuring the fair value of the share options granted. However, if the reload feature was not taken into account, then when the reload option is granted, it should be accounted for as a new share option grant.

BC192 Many respondents to ED 2 agreed with the proposals in ED 2. However, some disagreed. For example, some disagreed with there being a choice of treatments. Some respondents supported always treating reload options granted as new grants whereas others supported always including the reload feature in the grant date valuation. Some expressed concerns about the practicality of including the reload feature in the grant date valuation. After reconsidering this issue, the Board concluded that the reload feature should not be included in the grant date valuation and therefore all reload options granted should be accounted for as new share option grants.

BC193 There may be other features of employee (and other) share options that the Board has not yet considered. But even if the Board were to consider every conceivable feature of employee (and other) share options that exist at present, new features might be developed in the future.

BC194 The Board therefore concluded that the IFRS should focus on setting out clear principles to be applied to share-based payment transactions, and provide guidance on the more common features of employee share options, but should not prescribe extensive application guidance, which would be likely to become outdated.

BC195 Nevertheless, the Board considered whether there are share options with such unusual or complex features that it is too difficult to make a reliable estimate of their fair value and, if so, what the accounting treatment should be.

BC196 SFAS 123 states that "it should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted" (paragraph 21). However, it states that, "in unusual circumstances, the terms of the stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted". The standard requires that, in such situations, measurement should be delayed until it is possible to estimate reasonably the

* P J Saly, R Jagannathan and S J Huddart. 1999. Valuing the Reload Features of Executive Stock Options. *Accounting Horizons* 13 (3): 219-240.

instrument's fair value. It notes that this is likely to be the date at which the number of shares to which the employee is entitled and the exercise price are determinable. This could be vesting date. The standard requires that estimates of compensation expense for earlier periods (i.e. until it is possible to estimate fair value) should be based on current intrinsic value.

BC197 The Board thought it unlikely that entities could not reasonably determine the fair value of share options at grant date, particularly after excluding vesting conditions* and reload features from the grant date valuation. The share options form part of the employee's remuneration package, and it seems reasonable to presume that an entity's management would consider the value of the share options to satisfy itself that the employee's remuneration package is fair and reasonable.

BC198 When it developed ED 2, the Board concluded that there should be no exceptions to the requirement to apply a fair value measurement basis, and therefore it was not necessary to include in the proposed IFRS specific accounting requirements for share options that are difficult to value.

BC199 However, after considering respondents' comments, particularly with regard to unlisted entities, the Board reconsidered this issue. The Board concluded that, in rare cases only, in which the entity could not estimate reliably the grant date fair value of the equity instruments granted, the entity should measure the equity instruments at intrinsic value, initially at grant date and subsequently at each reporting date until the final settlement of the share-based payment arrangement, with the effects of the remeasurement recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the share options are exercised, are forfeited (eg upon cessation of employment) or lapse (eg at the end of the option's life). For a grant of shares, the share-based payment arrangement is finally settled when the shares vest or are forfeited. This requirement would apply to all entities, including listed and unlisted entities.

Recognition and measurement of services received in an equity-settled share-based payment transaction

During the vesting period

BC200 In an equity-settled share-based payment transaction, the accounting objective is to recognise the goods or services received as consideration for the entity's equity instruments, measured at the fair value of those goods or services when received. For transactions in which the entity receives employee services, it is often difficult to measure directly the fair value of the services received. In this case, the Board concluded that the fair value of the equity instruments granted should be used as a surrogate measure of the fair value of the services received. This raises the question how to use that surrogate measure to derive an amount to attribute to the services received. Another related question is how the entity should determine when the services are received.

* i.e. vesting conditions other than market conditions.

BC201 Starting with the latter question, some argue that shares or share options are often granted to employees for past services rather than future services, or mostly for past services, irrespective of whether the employees are required to continue working for the entity for a specified future period before their rights to those shares or share options vest. Conversely, some argue that shares or share options granted provide a future incentive to the employees and those incentive effects continue after vesting date, which implies that the entity receives services from employees during a period that extends beyond vesting date. For share options in particular, some argue that employees render services beyond vesting date, because employees are able to benefit from an option's time value between vesting date and exercise date only if they continue to work for the entity (since usually a departing employee must exercise the share options within a short period, otherwise they are forfeited).

BC202 However, the Board concluded that if the employees are required to complete a specified service period to become entitled to the shares or share options, this requirement provides the best evidence of when the employees render services in return for the shares or share options. Consequently, the Board concluded that the entity should presume that the services are received during the vesting period. If the shares or share options vest immediately, it should be presumed that the entity has already received the services, in the absence of evidence to the contrary. An example of when immediately vested shares or share options are not for past services is when the employee concerned has only recently begun working for the entity, and the shares or share options are granted as a signing bonus. But in this situation, it might nevertheless be necessary to recognise an expense immediately, if the future employee services do not meet the definition of an asset.

BC203 Returning to the first question in paragraph BC200, when the Board developed ED 2 it developed an approach whereby the fair value of the shares or share options granted, measured at grant date and allowing for all vesting conditions, is divided by the number of units of service expected to be received to determine the deemed fair value of each unit of service subsequently received.

BC204 For example, suppose that the fair value of share options granted, before taking into account the possibility of forfeiture, is CU750,000. Suppose that the entity estimates the possibility of forfeiture because of failure of the employees to complete the required three-year period of service is 20 per cent (based on a weighted average probability), and hence it estimates the fair value of the options granted at CU600,000 (CU750,000 × 80%). The entity expects to receive 1,350 units of service over the three-year vesting period.

BC205 Under the units of service method proposed in ED 2, the deemed fair value per unit of service subsequently received is CU444.44 (CU600,000/1,350). If everything turns out as expected, the amount recognised for services received is CU600,000 (CU444.44 × 1,350).

BC206 This approach is based on the presumption that there is a fairly bargained contract at grant date. Thus the entity has granted share options valued at CU600,000 and expects to receive services valued at CU600,000 in return. It does not expect all share options granted to vest because it does not expect all employees to complete three years' service. Expectations of forfeiture because of employee departures are taken into account when estimating the fair value of the share options granted, and when determining the fair value of the services to be received in return.

BC207 Under the units of service method, the amount recognised for services received during the vesting period might exceed CU600,000, if the entity receives more services than expected. This is because the objective is to account for the services subsequently received, not the fair value of the share options granted. In other words, the objective is not to estimate the fair value of the share options granted and then spread that amount over the vesting period. Rather, the objective is to account for the services subsequently received, because it is the receipt of those services that causes a change in net assets and hence a change in equity. Because of the practical difficulty of valuing those services directly, the fair value of the share options granted is used as a surrogate measure to determine the fair value of each unit of service subsequently received, and therefore the transaction amount is dependent upon the number of units of service actually received. If more are received than expected, the transaction amount will be greater than CU600,000. If fewer services are received, the transaction amount will be less than CU600,000.

BC208 Hence, a grant date measurement method is used as a practical expedient to achieve the accounting objective, which is to account for the services actually received in the vesting period. The Board noted that many who support grant date measurement do so for reasons that focus on the entity's commitments under the contract, not the services received. They take the view that the entity has conveyed to its employees valuable equity instruments at grant date and that the accounting objective should be to account for the equity instruments conveyed. Similarly, supporters of vesting date measurement argue that the entity does not convey valuable equity instruments to the employees until vesting date, and that the accounting objective should be to account for the equity instruments conveyed at vesting date. Supporters of exercise date measurement argue that, ultimately, the valuable equity instruments conveyed by the entity to the employees are the shares issued on exercise date and the objective should be to account for the value given up by the entity by issuing equity instruments at less than their fair value.

BC209 Hence all of these arguments for various measurement dates are focused entirely on what the entity (or its shareholders) has given up under the share-based payment arrangement, and accounting for that sacrifice. Therefore, if 'grant date measurement' were applied as a matter of principle, the primary objective would be to account for the value of the rights granted. Depending on whether the services have already been received and whether a prepayment for services to be received in the future meets the definition of an asset, the other side of the transaction would either be recognised as an expense at grant date, or capitalised as a prepayment and amortised over some period of time, such as over the vesting period or over the expected life of the share option. Under this view of grant date measurement, there would be no subsequent adjustment for actual outcomes. No matter how many share options vest or how many share options are exercised, that does not change the value of the rights given to the employees at grant date.

BC210 Therefore, the reason why some support grant date measurement differs from the reason why the Board concluded that the fair value of the equity instruments granted should be measured at grant date. This means that some will have different views about the consequences of applying grant date measurement. Because the units of service method is based on using the fair value of the equity instruments granted, measured at grant date, as a surrogate measure of the fair value of the services received, the total transaction amount is dependent upon the number of units of service received.

© Copyright

BC211 Some respondents to ED 2 disagreed with the units of service method in principle, because they did not accept that the fair value of the services received should be the accounting focus. Rather, the respondents focused on accounting for the 'cost' of the equity instruments issued (ie the credit side of the transaction rather than the debit side), and took the view that if the share options or shares are forfeited, no cost was incurred, and thus any amounts recognised previously should be reversed, as would happen with a cash-settled transaction.

BC212 Some respondents also disagreed with the treatment of performance conditions under the units of service method, because if the employee completes the required service period but the equity instruments do not vest because of the performance condition not being satisfied, there is no reversal of amounts recognised during the vesting period. Some argue that this result is unreasonable because, if the performance condition is not satisfied, then the employee did not perform as required, hence it is inappropriate to recognise an expense for services received or consumed, because the entity did not receive the specified services.

BC213 The Board considered and rejected the above arguments made against the units of service method in principle. For example, the Board noted that the objective of accounting for the services received, rather than the cost of the equity instruments issued, is consistent with the accounting treatment of other issues of equity instruments, and with the IASB *Framework*. With regard to performance conditions, the Board noted that the strength of the argument in paragraph BC212 depends on the extent to which the employee has control or influence over the achievement of the performance target. One cannot necessarily conclude that the non-attainment of the performance target is a good indication that the employee has failed to perform his/her side of the arrangement (ie failed to provide services).

BC214 Therefore, the Board was not persuaded by those respondents who disagreed with the units of service method in principle. However, the Board also noted that some respondents raised practical concerns about the method. Some respondents regarded the units of service method as too complex and burdensome to apply in practice. For example, if an entity granted share options to a group of employees but did not grant the same number of share options to each employee (eg the number might vary according to their salary or position in the entity), it would be necessary to calculate a different deemed fair value per unit of service for each individual employee (or for each subgroup of employees, if there are groups of employees who each received the same number of options). Then the entity would have to track each employee, to calculate the amount to recognise for each employee. Furthermore, in some circumstances, an employee share or share option scheme might not require the employee to forfeit the shares or share options if the employee leaves during the vesting period in specified circumstances. Under the terms of some schemes, employees can retain their share options or shares if they are classified as a 'good leaver', eg a departure resulting from circumstances not within the employee's control, such as compulsory retirement, ill health or redundancy. Therefore, in estimating the possibility of forfeiture, it is not simply a matter of estimating the possibility of employee departure during the vesting period. It is also necessary to estimate whether those departures will be 'good leavers' or 'bad leavers'. And because the share options or shares will vest upon departure of 'good leavers', the expected number of units to be received and the expected length of the vesting period will be shorter for this group of employees. These factors would need to be incorporated into the application of the units of service method.

BC215 Some respondents also raised practical concerns about applying the units of service method to grants with performance conditions. These concerns include the difficulty of incorporating non-market and complex performance conditions into the grant date valuation, the additional subjectivity that this introduces, and that it was unclear how to apply the method when the length of the vesting period is not fixed, because it depends on when a performance condition is satisfied.

BC216 The Board considered the practical concerns raised by respondents, and obtained further advice from valuation experts concerning the difficulties highlighted by respondents of including non-market performance conditions in the grant date valuation. Because of these practical considerations, the Board concluded that the units of service method should not be retained in the IFRS. Instead, the Board decided to adopt the modified grant date method applied in SFAS 123. Under this method, service conditions and non-market performance conditions are excluded from the grant date valuation (ie the possibility of forfeiture is not taken into account when estimating the grant date fair value of the share options or other equity instruments, thereby producing a higher grant date fair value), but are instead taken into account by requiring that the transaction amount be based on the number of equity instruments that eventually vest.[*] Under this method, 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), eg the counterparty fails to complete a specified service period, or a performance condition (other than a market condition) is not satisfied.

BC217 However, as discussed earlier (paragraphs BC180-BC182), the Board decided that it should not permit the choice available in SFAS 123 to account for the effects of expected or actual forfeitures of share options or other equity instruments because of failure to satisfy a service condition. The Board decided that the IFRS should require an entity to estimate the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from previous estimates.

Share options that are forfeited or lapse after the end of the vesting period

BC218 Some share options might not be exercised. For example, a share option holder is unlikely to exercise a share option if the share price is below the exercise price throughout the exercise period. Once the last date for exercise is passed, the share option will lapse.

BC219 The lapse of a share option at the end of the exercise period does not change the fact that the original transaction occurred, i.e. goods or services were received as consideration for the issue of an equity instrument (the share option). The lapsing of the share option does not represent a gain to the entity, because there is no change to the entity's net assets. In other words, although some might see such an event as being a benefit to the remaining shareholders, it has no effect on the entity's financial position. In effect, one type of equity interest (the share option holders' interest) becomes part of another type of equity interest (the shareholders' interest). The Board therefore

[*] The treatment of market conditions is discussed in paragraphs BC183 and BC184. As noted in paragraph BC184, the practical difficulties that led the Board to conclude that non-market conditions should be dealt with via the modified grant date method rather than being included in the grant date valuation do not apply to market conditions, because market conditions can be incorporated into option pricing models.

concluded that the only accounting entry that might be required is a movement within equity, to reflect that the share options are no longer outstanding (ie as a transfer from one type of equity interest to another).

BC220 This is consistent with the treatment of other equity instruments, such as warrants issued for cash. When warrants subsequently lapse unexercised, this is not treated as a gain; instead the amount previously recognised when the warrants were issued remains within equity.*

BC221 The same analysis applies to equity instruments that are forfeited after the end of the vesting period. For example, an employee with vested share options typically must exercise those options within a short period after cessation of employment, otherwise the options are forfeited. If the share options are not in the money, the employee is unlikely to exercise the options and hence they will be forfeited. For the same reasons as are given in paragraph BC219, no adjustment is made to the amounts previously recognised for services received as consideration for the share options. The only accounting entry that might be required is a movement within equity, to reflect that the share options are no longer outstanding.

Modifications to the terms and conditions of share-based payment arrangements

BC222 An entity might modify the terms of or conditions under which the equity instruments were granted. For example, the entity might reduce the exercise price of share options granted to employees (ie reprice the options), which increases the fair value of those options. During the development of ED 2, the Board focused mainly on the repricing of share options.

BC223 The Board noted that the IASC/G4+1 Discussion Paper argued that if the entity reprices its share options it has, in effect, replaced the original share option with a more valuable share option. The entity presumably believes that it will receive an equivalent amount of benefit from doing so, because otherwise the directors would not be acting in the best interests of the entity or its shareholders. This suggests that the entity expects to receive additional or enhanced employee services equivalent in value to the incremental value of the repriced share options. The Discussion Paper therefore proposed that the incremental value given (ie the difference between the value of the original share option and the value of the repriced share option, as at the date of repricing) should be recognised as additional remuneration expense. Although the Discussion Paper discussed repricing in the context of vesting date measurement, SFAS 123, which applies a grant date measurement basis for employee share-based payment, contains reasoning similar to that in the Discussion Paper.

BC224 This reasoning seems appropriate if grant date measurement is applied on the grounds that the entity made a payment to the employees on grant date by granting them valuable rights to equity instruments of the entity. If the entity is prepared to replace that payment with a more valuable payment, it must believe it will receive an equivalent amount of benefit from doing so.

* However, an alternative approach is followed in some jurisdictions (e.g. Japan and the UK), where the entity recognises a gain when warrants lapse. But under the *Framework*, recognising a gain on the lapse of warrants would be appropriate only if warrants were liabilities, which they are not.

BC225 The same conclusion is drawn if grant date measurement is applied on the grounds that some type of equity interest is created at grant date, and thereafter changes in the value of that equity interest accrue to the option holders as equity participants, not as employees. Repricing is inconsistent with the view that share option holders bear changes in value as equity participants. Hence it follows that the incremental value has been granted to the share option holders in their capacity as employees (rather than equity participants), as part of their remuneration for services to the entity. Therefore additional remuneration expense arises in respect of the incremental value given.

BC226 It could be argued that if (a) grant date measurement is used as a surrogate measure of the fair value of the services received and (b) the repricing occurs between grant date and vesting date and (c) the repricing merely restores the share option's original value at grant date, then the entity may not receive additional services. Rather, the repricing might simply be a means of ensuring that the entity receives the services it originally expected to receive when the share options were granted. Under this view, it is not appropriate to recognise additional remuneration expense to the extent that the repricing restores the share option's original value at grant date.

BC227 Some argue that the effect of a repricing is to create a new deal between the entity and its employees, and therefore the entity should estimate the fair value of the repriced share options at the date of repricing to calculate a new measure of the fair value of the services received subsequent to repricing. Under this view, the entity would cease using the grant date fair value of the share options when measuring services received after the repricing date, but without reversal of amounts recognised previously. The entity would then measure the services received between the date of repricing and the end of the vesting period by reference to the fair value of the modified share options, measured at the date of repricing. If the repricing occurs after the end of the vesting period, the same process applies. That is to say, there is no adjustment to previously recognised amounts, and the entity recognises—either immediately or over the vesting period, depending on whether the employees are required to complete an additional period of service to become entitled to the repriced share options—an amount equal to the fair value of the modified share options, measured at the date of repricing.

BC228 In the context of measuring the fair value of the equity instruments as a surrogate measure of the fair value of the services received, after considering the above points, the Board concluded when it developed ED 2 that the incremental value granted on repricing should be taken into account when measuring the services received, because:

(a) there is an underlying presumption that the fair value of the equity instruments, at grant date, provides a surrogate measure of the fair value of the services received. That fair value is based on the share option's original terms and conditions. Therefore, if those terms or conditions are modified, the modification should be taken into account when measuring the services received.

(b) a share option that will be repriced if the share price falls is more valuable than one that will not be repriced. Therefore, by presuming at grant date that the share option will not be repriced, the entity underestimated the fair value of that option. The Board concluded that, because it is impractical to include the possibility of repricing in the estimate of fair value at grant date, the incremental value granted on repricing should be taken into account as and when the repricing occurs.

BC229 Many of the respondents to ED 2 who addressed the issue of repricing agreed with the proposed requirements. After considering respondents' comments, the Board decided to retain the approach to repricing as proposed in ED 2, i.e. recognise the incremental value granted on repricing, in addition to continuing to recognise amounts based on the fair value of the original grant.

BC230 The Board also discussed situations in which repricing might be effected by cancelling share options and issuing replacement share options. For example, suppose an entity grants at-the-money share options with an estimated fair value of CU20 each. Suppose the share price falls, so that the share options become significantly out of the money, and are now worth CU2 each. Suppose the entity is considering repricing, so that the share options are again at the money, which would result in them being worth, say, CU10 each. (Note that the share options are still worth less than at grant date, because the share price is now lower. Other things being equal, an at-the-money option on a low priced share is worth less than an at-the-money option on a high priced share.)

BC231 Under ED 2's proposed treatment of repricing, the incremental value given on repricing (CU10 – CU2 = CU8 increment in fair value per share option) would be accounted for when measuring the services rendered, resulting in the recognition of additional expense, i.e. additional to any amounts recognised in the future in respect of the original share option grant (valued at CU20). If the entity instead cancelled the existing share options and then issued what were, in effect, replacement share options, but treated the replacement share options as a new share option grant, this could reduce the expense recognised. Although the new grant would be valued at CU10 rather than incremental value of CU8, the entity would not recognise any further expense in respect of the original share option grant, valued at CU20. Although some regard such a result as appropriate (and consistent with their views on repricing, as explained in paragraph BC227), it is inconsistent with the Board's treatment of repricing.

BC232 By this means, the entity could, in effect, reduce its remuneration expense if the share price falls, without having to increase the expense if the share price rises (because no repricing would be necessary in this case). In other words, the entity could structure a repricing so as to achieve a form of service date measurement if the share price falls and grant date measurement if the share price rises, i.e. an asymmetrical treatment of share price changes.

BC233 When it developed ED 2, the Board concluded that if an entity cancels a share or share option grant during the vesting period (other than cancellations because of employees' failing to satisfy the vesting conditions), it should nevertheless continue to account for services received, as if that share or share option grant had not been cancelled. In the Board's view, it is very unlikely that a share or share option grant would be cancelled without some compensation to the counterparty, either in the form of cash or replacement share options. Moreover, the Board saw no difference between a repricing of share options and a cancellation of share options followed by the granting of replacement share options at a lower exercise price, and therefore concluded that the accounting treatment should be the same. If cash is paid on the cancellation of the share or share option grant, the Board concluded that the payment should be accounted for as the repurchase of an equity interest, ie as a deduction from equity.

BC234 The Board noted that its proposed treatment means that an entity would continue to recognise services received during the remainder of the original vesting period, even though the entity might have paid cash compensation to the counterparty upon cancellation of the share or share option grant. The Board discussed an alternative

approach applied in SFAS 123: if an entity settles unvested shares or share options in cash, those shares or share options are treated as having immediately vested. The entity is required to recognise immediately an expense for the amount of compensation expense that would otherwise have been recognised during the remainder of the original vesting period. Although the Board would have preferred to adopt this approach, it would have been difficult to apply in the context of the proposed accounting method in ED 2, given that there is not a specific amount of unrecognised compensation expense—the amount recognised in the future would have depended on the number of units of service received in the future.

BC235 Many respondents who commented on the treatment of cancellations disagreed with the proposals in ED 2. They commented that it was inappropriate to continue recognising an expense after a grant has been cancelled. Some suggested other approaches, including the approach applied in SFAS 123. After considering these comments, and given that the Board had decided to replace the units of service method with the modified grant date method in SFAS 123, the Board concluded that it should adopt the same approach as applied in SFAS 123 to cancellations and settlements. Under SFAS 123, a settlement (including a cancellation) is regarded as resulting in the immediate vesting of the equity instruments. The amount of remuneration expense measured at grant date but not yet recognised is recognised immediately at the date of settlement or cancellation.

BC236 In addition to the above issues, during its redeliberation of the proposals in ED 2 the Board also considered more detailed issues relating to modifications and cancellations. Specifically, the Board considered:

(a) a modification that results in a decrease in fair value (i.e. the fair value of the modified instrument is less than the fair value of the original instrument, measured at the date of the modification).

(b) a change in the number of equity instruments granted (increase and decrease).

(c) a change in services conditions, thereby changing the length of the vesting period (increase and decrease).

(d) a change in performance conditions, thereby changing the probability of vesting (increase and decrease).

(e) a change in the classification of the grant, from equity to liabilities.

BC237 The Board concluded that having adopted a grant date measurement method, the requirements for modifications and cancellations should ensure that the entity cannot, by modifying or cancelling the grant of shares or share options, avoid recognising remuneration expense based on the grant date fair values. Therefore, the Board concluded that, for arrangements that are classified as equity-settled arrangements (at least initially), the entity must recognise the grant date fair value of the equity instruments over the vesting period, unless the employee fails to vest in those equity instruments under the terms of the original vesting conditions.

© Copyright

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.

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.

© Copyright

BC242 Because cash-settled SARs involve an outflow of cash (rather than the issue of equity instruments) cash SARs should be accounted for in accordance with the usual accounting for similar liabilities. That sounds straightforward, but there are some questions to consider:

(a) should a liability be recognised before vesting date, i.e. before the employees have fulfilled the conditions to become unconditionally entitled to the cash payment?

(b) if so, how should that liability be measured?

(c) how should the expense be presented in the income statement?

Is there a liability before vesting date?

BC243 It could be argued that the entity does not have a liability until vesting date, because the entity does not have a present obligation to pay cash to the employees until the employees fulfil the conditions to become unconditionally entitled to the cash; between grant date and vesting date there is only a contingent liability.

BC244 The Board noted that this argument applies to all sorts of employee benefits settled in cash, not just SARs. For example, it could be argued that an entity has no liability for pension payments to employees until the employees have met the specified vesting conditions. This argument was considered by IASC in IAS 19 *Employee Benefits*. The Basis for Conclusions states:

> Paragraph 54 of the new IAS 19 summarises the recognition and measurement of liabilities arising from defined benefit plans…Paragraph 54 of the new IAS 19 is based on the definition of, and recognition criteria for, a liability in IASC's *Framework*…The Board believes that an enterprise has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan…The Board believes that an obligation exists even if a benefit is not vested, in other words if the employee's right to receive the benefit is conditional upon future employment. For example, consider an enterprise that provides a benefit of 100 to employees who remain in service for two years. At the end of the first year, the employee and the enterprise are not in the same position as at the beginning of the first year, because the employee will only need to work for one year, instead of two, before becoming entitled to the benefit. Although there is a possibility that the benefit may not vest, that difference is an obligation and, in the Board's view, should result in the recognition of a liability at the end of the first year. The measurement of that obligation at its present value reflects the enterprise's best estimate of the probability that the benefit may not vest. (IAS 19, Basis for Conclusions, paragraphs 11-14)

BC245 Therefore, the Board concluded that, to be consistent with IAS 19, which covers other cash-settled employee benefits, a liability should be recognised in respect of cash-settled SARs during the vesting period, as services are rendered by the employees. Thus, no matter how the liability is measured, the Board concluded that it should be accrued over the vesting period, to the extent that the employees have performed their side of the arrangement. For example, if the terms of the arrangement require the employees to perform services over a three-year period, the liability would be accrued over that three-year period, consistently with the treatment of other cash-settled employee benefits.

How should the liability be measured?

BC246 A simple approach would be to base the accrual on the entity's share price at the end of each reporting period. If the entity's share price increased over the vesting period, expenses would be larger in later reporting periods compared with earlier reporting periods. This is because each reporting period will include the effects of (a) an increase in the liability in respect of the employee services received during that reporting period and (b) an increase in the liability attributable to the increase in the entity's share price during the reporting period, which increases the amount payable in respect of past employee services received.

BC247 This approach is consistent with SFAS 123 (paragraph 25) and FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

BC248 However, this is not a fair value approach. Like share options, the fair value of SARs includes both their intrinsic value (the increase in the share price to date) and their time value (the value of the right to participate in future increases in the share price, if any, that may occur between the valuation date and the settlement date). An option pricing model can be used to estimate the fair value of SARs.

BC249 Ultimately, however, no matter how the liability is measured during the vesting period, the liability—and therefore the expense—will be remeasured, when the SARs are settled, to equal the amount of the cash paid out. The amount of cash paid will be based on the SARs' intrinsic value at the settlement date. Some support measuring the SAR liability at intrinsic value for this reason, and because intrinsic value is easier to measure.

BC250 The Board concluded that measuring SARs at intrinsic value would be inconsistent with the fair value measurement basis applied, in most cases, in the rest of the IFRS. Furthermore, although a fair value measurement basis is more complex to apply, it was likely that many entities would be measuring the fair value of similar instruments regularly, e.g. new SAR or share option grants, which would provide much of the information required to remeasure the fair value of the SAR at each reporting date. Moreover, because the intrinsic value measurement basis does not include time value, it is not an adequate measure of either the SAR liability or the cost of services consumed.

BC251 The question of how to measure the liability is linked with the question how to present the associated expense in the income statement, as explained below.

How should the associated expense be presented in the income statement?

BC252 SARs are economically similar to share options. Hence some argue that the accounting treatment of SARs should be the same as the treatment of share options, as discussed earlier (paragraph BC113). However, as noted in paragraphs BC240 and BC241, in an equity-settled transaction there is one change in net assets (the goods or services received) whereas in a cash-settled transaction there are two changes in net assets (the goods or services received and the cash or other assets paid out). To differentiate between the effects of each change in net assets in a cash-settled transaction, the expense could be separated into two components:

- an amount based on the fair value of the SARs at grant date, recognised over the vesting period, in a manner similar to accounting for equity-settled

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 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.

© Copyright

The terms of the arrangement provide the employee with a choice of settlement

BC258 Share-based payment transactions without cash alternatives do not give rise to liabilities under the *Framework*, because the entity is not required to transfer cash or other assets to the other party. However, this is not so if the contract between the entity and the employee gives the employee the contractual right to demand the cash alternative. In this situation, the entity has an obligation to transfer cash to the employee and hence a liability exists. Furthermore, because the employee has the right to demand settlement in equity instead of cash, the employee also has a conditional right to equity instruments. Hence, on grant date the employee was granted rights to a compound financial instrument, ie a financial instrument that includes both debt and equity components.

BC259 It is common for the alternatives to be structured so that the fair value of the cash alternative is always the same as the fair value of the equity alternative, eg where the employee has a choice between share options and SARs. However, if this is not so, then the fair value of the compound financial instrument will usually exceed both the individual fair value of the cash alternative (because of the possibility that the shares or share options may be more valuable than the cash alternative) and that of the shares or options (because of the possibility that the cash alternative may be more valuable than the shares or options).

BC260 Under IAS 32, a financial instrument that is accounted for as a compound instrument is separated into its debt and equity components, by allocating the proceeds received for the issue of a compound instrument to its debt and equity components. This entails determining the fair value of the liability component and then assigning the remainder of the proceeds received to the equity component. This is possible if those proceeds are cash or non-cash consideration whose fair value can be reliably measured. If that is not the case, it will be necessary to estimate the fair value of the compound instrument itself.

BC261 The Board concluded that the compound instrument should be measured by first valuing the liability component (the cash alternative) and then valuing the equity component (the equity instrument)—with that valuation taking into account that the employee must forfeit the cash alternative to receive the equity instrument—and adding the two component values together. This is consistent with the approach adopted in IAS 32, whereby the liability component is measured first and the residual is allocated to equity. If the fair value of each settlement alternative is always the same, then the fair value of the equity component of the compound instrument will be zero and hence the fair value of the compound instrument will be the same as the fair value of the liability component.

BC262 The Board concluded that the entity should separately account for the services rendered in respect of each component of the compound financial instrument, to ensure consistency with the IFRS's requirements for equity-settled and cash-settled share-based payment transactions. Hence, for the debt component, the entity should recognise the services received, and a liability to pay for those services, as the employees render services, in the same manner as other cash-settled share-based payment transactions (eg SARs). For the equity component (if any), the entity should recognise the services received, and an increase in equity, as the employees render services, in the same way as other equity-settled share-based payment transactions.

© Copyright

BC263 The Board concluded that the liability should be remeasured to its fair value as at the date of settlement, before accounting for the settlement of the liability. This ensures that, if the entity settles the liability by issuing equity instruments, the resulting increase in equity is measured at the fair value of the consideration received for the equity instruments issued, being the fair value of the liability settled.

BC264 The Board also concluded that, if the entity pays cash rather than issuing equity instruments on settlement, any contributions to equity previously recognised in respect of the equity component should remain in equity. By electing to receive cash rather than equity instruments, the employee has surrendered his/her rights to receive equity instruments. That event does not cause a change in net assets and hence there is no change in total equity. This is consistent with the Board's conclusions on other lapses of equity instruments (see paragraphs BC218-BC221).

The terms of the arrangement provide the entity with a choice of settlement

BC265 For share-based payment transactions in which the terms of the arrangement provide the entity with a choice of whether to settle in cash or by issuing equity instruments, the entity would need first to determine whether it has an obligation to settle in cash and therefore does not, in effect, have a choice of settlement. Although the contract might specify that the entity can choose whether to settle in cash or by issuing equity instruments, the Board concluded that the entity will have an obligation to settle in cash if the choice of settlement in equity has no commercial substance (eg because the entity is legally prohibited from issuing shares), or if the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement. The entity will also have an obligation to settle in cash if the shares issued (including shares issued upon the exercise of share options) are redeemable, either mandatorily (eg upon cessation of employment) or at the counterparty's option.

BC266 During its redeliberations of the proposals in ED 2, the Board noted that the classification as liabilities or equity of arrangements in which the entity appears to have the choice of settlement differs from the classification under IAS 32, which requires such an arrangement to be classified either wholly as a liability (if the contract is a derivative contract) or as a compound instrument (if the contract is a non-derivative contract). However, consistently with its conclusions on the other differences between IFRS 2 and IAS 32 (see paragraphs BC106-BC110), the Board decided to retain this difference, pending the outcome of its longer-term Concepts project, which includes reviewing the definitions of liabilities and equity.

BC267 Even if the entity is not obliged to settle in cash until it chooses to do so, at the time it makes that election a liability will arise for the amount of the cash payment. This raises the question how to account for the debit side of the entry. It could be argued that any difference between (a) the amount of the cash payment and (b) the total expense recognised for services received and consumed up to the date of settlement (which would be based on the grant date value of the equity settlement alternative) should be recognised as an adjustment to the employee remuneration expense. However, given that the cash payment is to settle an equity interest, the Board concluded that it is consistent with the *Framework* to treat the cash payment as the repurchase of an equity interest, ie as a deduction from equity. In this case, no adjustment to remuneration expense is required on settlement.

BC268 However, the Board concluded that an additional expense should be recognised if the entity chooses the settlement alternative with the higher fair value because, given that the entity has voluntarily paid more than it needed to, presumably it expects to receive (or has already received) additional services from the employees in return for the additional value given.

Share-based payment transactions among group entities (2009 amendments)*

BC268A This section summarises the Board's considerations when finalising its proposals contained in the exposure draft *Group Cash-settled Share-based Payment Transactions* published in December 2007. Until the Board amended IFRS 2 in 2009, IFRIC 11 provided guidance on how an entity that received the goods or services from its suppliers should account for some specific group equity-settled share-based payment transactions in its separate or individual financial statements. Therefore, the amendments issued in June 2009 incorporated substantially the same consensus contained in IFRIC 11. The relevant matters the IFRIC considered when reaching the consensus contained in IFRIC 11, as approved by the Board, are also carried forward in this section.

BC268B The exposure draft published in December 2007 addressed two arrangements in which the parent (not the entity itself) has an obligation to make the required cash payments to the suppliers of the entity:

(a) Arrangement 1 – the supplier of the entity will receive cash payments that are linked to the price of the equity instruments of the entity.

(b) Arrangement 2 – the supplier of the entity will receive cash payments that are linked to the price of the equity instruments of the parent of the entity.

BC268C The Board noted that like those group equity-settled share-based payment transactions originally addressed in IFRIC 11, the two arrangements described in paragraph BC268B did not meet the definition of either an equity-settled or a cash-settled share-based payment transaction. The Board considered whether a different conclusion should be reached for such arrangements merely because they are cash-settled rather than equity-settled. Paragraphs BC22A–BC22F explain the Board's considerations in finalising the amendments to clarify the scope of IFRS 2. The section below summarises the Board's considerations in finalising the amendments relating to the measurement of such transactions.

BC268D The Board noted that the arrangements described in paragraph BC268B are

(a) for the purpose of providing benefits to the employees of the subsidiary in return for employee services, and

(b) share-based and cash-settled.

In addition, the Board noted that the guidance in paragraph 3 (now superseded by paragraph 3A) already stated that when a shareholder transferred equity instruments of the entity (or another group entity), the transaction would be within the scope of IFRS 2 for the entity receiving the goods or services.

* Paragraphs BC268A–BC268O are added as a consequence of amendments to IFRS 2 *Group Cash-settled Share-based Payment Transactions* issued in June 2009.

BC268E For these reasons, in the exposure draft published in December 2007 the Board proposed to amend IFRS 2 and IFRIC 11 to require that, in the separate or individual financial statements of the entity receiving the goods or services, the entity should measure the employee services in accordance with the requirements applicable to cash-settled share-based payment transactions on the basis of the fair value of the corresponding liability incurred by the parent. Specifically, until the liability incurred by the parent is settled, the entity should recognise any changes in the fair value of the liability in profit or loss and changes in the entity's equity as adjustments to contributions from the parent.

BC268F Because group cash-settled share-based payment transactions did not meet the definition of either an equity-settled or a cash-settled share-based payment transaction, some respondents did not object to measuring them as cash-settled on the basis that the accounting reflects the form of the payment received by the entity's suppliers. However, many respondents questioned the basis for the conclusions reached, citing reasons that included:

(a) the lack of a 'push-down' accounting concept in current IFRSs that would require the parent's costs incurred on behalf of the subsidiary to be attributed to the subsidiary,

(b) conflicts with the *Framework* and with other IFRSs that prohibit remeasurement of equity, and

(c) conflicts with the rationale in the Basis for Conclusions on IFRS 2 related to the remeasurement of cash-settled share-based payment transactions when the entity itself has no obligation to its suppliers.

BC268G The Board agreed with respondents that the entity receiving goods or services has no obligation to distribute assets and that the parent's settlement is an equity contribution to the entity. The Board noted that regardless of how such group transactions are structured or accounted for in the separate or individual financial statements of the group entities, the accounting measurement in the consolidated financial statements of the group will be the same. The Board also noted that the share-based payment expense measured on grant date results in the same fair value for both the entity receiving goods or services and the entity settling the transaction, regardless of whether it is measured as equity-settled or as cash-settled.

BC268H To address the comments received from respondents, the Board reviewed two issues to determine the appropriate subsequent measurement in the separate or individual financial statements of the entity receiving the goods or services. The first issue was whether the entity should recognise in its separate or individual financial statements:

(a) Approach 1 – an expense of the same amount as in the consolidated financial statements, or

(b) Approach 2 – an expense measured by classifying the transaction as equity-settled or cash-settled evaluated from its own perspective, which may not always be the same as the amount recognised by the consolidated group.

BC268I The Board noted that IFRSs have no broad-based guidance to address push-down accounting or the accounting in separate or individual financial statements for the allocation of costs among group entities. When addressing defined benefit plans that share risks between entities under common control, IAS 19 requires an expense to be recognised by the subsidiary on the basis of the cash amount charged by the group plan. When there are no repayment arrangements, in the separate or individual financial statements, the subsidiary should recognise a cost equal to its contribution payable for the period. This is consistent with Approach 2 described in paragraph BC268H.

BC268J The Board therefore decided to adopt Approach 2. However, the approach adopted in IFRS 2 is different from that in IAS 19 in that the entity receiving goods or services in a share-based payment transaction recognises an expense even when it has no obligation to pay cash or other assets. The Board concluded that this approach is consistent with the expense attribution principles underlying IFRS 2.

BC268K The Board noted that Approach 2 is consistent with the rationale that the information provided by general purpose financial reporting should 'reflect the perspective of the entity rather than the perspective of the entity's equity investors ….' because the reporting entity is deemed to have substance of its own, separate from that of its owners. Approach 1 reflects the perspective of the entity's owners (the group) rather than the rights and obligations of the entity itself.

BC268L The Board also noted that the consensus reached in IFRIC 11 reflected Approach 1 described in paragraph BC268H for some scenarios and Approach 2 for others. The Board concluded that this was undesirable and decided that there should be a single approach to measurement that would apply in all situations.

BC268M The second issue the Board considered was identifying the criteria for classifying group share-based payment transactions as equity-settled or cash-settled. How a transaction is classified determines the subsequent measurement in the separate or individual financial statements of both the entity receiving the goods or services and the entity settling the transaction, if different. The Board reviewed the two classification criteria set out in the consensus in IFRIC 11 for group equity-settled transactions:

(a) based on the nature of the award given to the employees—therefore, classified as *equity-settled* if the entity's own equity instruments are given, regardless of which entity grants or settles it; otherwise classified as *cash-settled* even when the entity receiving the goods or services has no obligation.

(b) based on the entity's own rights and obligations—therefore, classified as *cash-settled* if the entity has an obligation to settle, regardless of the nature of the consideration; otherwise classified as *equity-settled*.

BC268N The Board noted that, on its own, either of the two criteria described above would not consistently reflect the entity's perspective when assessing the appropriate classification for transactions described in paragraph BC268B. The Board concluded that the entity should consider both criteria in IFRIC 11, ie *equity-settled* when suppliers are given the entity's own equity instruments or when the entity receiving the goods or services has no obligation to settle and *cash-settled* in all other circumstances. The Board also noted that when the entity receiving goods or services has no obligation to deliver cash or other assets to its suppliers, accounting for the transaction as cash-settled in its separate or individual financial statements is not

appropriate. The equity-settled basis is more consistent with the principles and rationales in both IFRS 2 and IFRIC 11. Therefore, the Board decided that the entity receiving the goods or services should classify both of the group cash-settled share-based payment transactions described in paragraph BC268B as *equity-settled* in its separate or individual financial statements.

BC268O This conclusion is the main change to the proposals in the exposure draft. The Board concluded that the broader principles it developed during its redeliberations addressed the three main concerns expressed by respondents described in paragraph BC268F. Those principles apply to all group share-based payment transactions, whether they are cash-settled or equity-settled. The Board's conclusions do not result in any changes to the guidance in IFRIC 11 that addressed similar group equity-settled share-based payment transactions. Other than the change described above, the Board reaffirmed the proposals in the exposure draft. Therefore, the Board concluded that it was not necessary to re-expose the amendments before finalising them.

Transfers of employees between group entities (paragraphs B58–B61)

BC268P When it developed the consensus in IFRIC 11, the IFRIC noted that some share-based payment arrangements involve a parent granting rights to the employees of more than one subsidiary with a vesting condition that requires the employees to work for the group for a particular period. Sometimes, an employee of one subsidiary transfers employment to another subsidiary during the vesting period, without the employee's rights under the original share-based payment arrangements being affected.

BC268Q The IFRIC noted that the terms of the original share-based payment arrangement require the employees to work for the group, rather than for a particular group entity. Thus, the IFRIC concluded that the change of employment should not result in a new grant of equity instruments in the financial statements of the subsidiary to which the employees transferred employment. The subsidiary to which the employee transfers employment should measure the fair value of the services received from the employee by reference to the fair value of the equity instruments at the date those equity instruments were originally granted to the employee by the parent. For the same reason, the IFRIC concluded that the transfer itself should not be treated as an employee's failure to satisfy a vesting condition. Thus, the transfer should not trigger any reversal of the charge previously recognised in respect of the services received from the employee in the separate or individual financial statements of the subsidiary from which the employee transfers employment.

BC268R The IFRIC noted that paragraph 19 of the IFRS requires the cumulative amount recognised for goods or services as consideration for the equity instruments granted to be based on the number of equity instruments that eventually vest. Accordingly, on a cumulative basis, no amount is recognised for goods or services if the equity instruments do not vest because of failure to satisfy a vesting condition other than a market condition as defined in Appendix A. Applying the principles in paragraph 19, the IFRIC concluded that when the employee fails to satisfy a vesting condition other than a market condition, the services from that employee recognised in the financial statements of each group entity during the vesting period should be reversed.

BC268S When finalising the 2009 amendments to IFRS 2 for group share-based payment transactions, the Board concluded that the guidance in IFRIC 11 should apply to all group share-based payment transactions classified as equity-settled in the entity's separate or individual financial statements in accordance with paragraphs 43A–43C.

© Copyright

Overall conclusions on accounting for employee share options

BC269 The Board first considered all major issues relating to the recognition and measurement of share-based payment transactions, and reached conclusions on those issues. It then drew some overall conclusions, particularly on the treatment of employee share options, which is one of the most controversial aspects of the project. In arriving at those conclusions, the Board considered the following issues:

- convergence with US GAAP
- recognition versus disclosure of expenses arising from employee share-based payment transactions
- reliability of measurement of the fair value of employee share options.

Convergence with US GAAP

BC270 Some respondents to the Discussion Paper and ED 2 urged the Board to develop an IFRS that was based on existing requirements under US generally accepted accounting principles (US GAAP).

BC271 More specifically, respondents urged the Board to develop a standard based on SFAS 123. However, given that convergence of accounting standards was commonly given as a reason for this suggestion, the Board considered US GAAP overall, not just one aspect of it. The main pronouncements of US GAAP on share-based payment are Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees*, and SFAS 123.

APB 25

BC272 APB 25 was issued in 1972. It deals with employee share plans only, and draws a distinction between non-performance-related (fixed) plans and performance-related and other variable plans.

BC273 For fixed plans, an expense is measured at intrinsic value (i.e. the difference between the share price and the exercise price), if any, at grant date. Typically, this results in no expense being recognised for fixed plans, because most share options granted under fixed plans are granted at the money. For performance-related and other variable plans, an expense is measured at intrinsic value at the measurement date. The measurement date is when both the number of shares or share options that the employee is entitled to receive and the exercise price are fixed. Because this measurement date is likely to be much later than grant date, any expense is subject to uncertainty and, if the share price is increasing, the expense for performance-related plans would be larger than for fixed plans.

BC274 In SFAS 123, the FASB noted that APB 25 is criticised for producing anomalous results and for lacking any underlying conceptual rationale. For example, the requirements of APB 25 typically result in the recognition of an expense for performance-related share options but usually no expense is recognised for fixed share options. This result is anomalous because fixed share options are usually more valuable at grant date than performance-related share options. Moreover, the omission of an expense for fixed share options impairs the quality of financial statements:

> The resulting financial statements are less credible than they could be, and the financial statements of entities that use fixed employee share options extensively are not comparable to those of entities that do not make significant use of fixed options. (SFAS 123, paragraph 56)

BC275 The Discussion Paper, in its discussion of US GAAP, noted that the different accounting treatments for fixed and performance-related plans also had the perverse effect of discouraging entities from setting up performance-related employee share plans.

SFAS 123

BC276 SFAS 123 was issued in 1995. It requires recognition of share-based payment transactions with parties other than employees, based on the fair value of the shares or share options issued or the fair value of the goods or services received, whichever is more reliably measurable. Entities are also encouraged, but not required, to apply the fair value accounting method in SFAS 123 to share-based payment transactions with employees. Generally speaking, SFAS 123 draws no distinction between fixed and performance-related plans.

BC277 If an entity applies the accounting method in APB 25 rather than that in SFAS 123, SFAS 123 requires disclosures of pro forma net income and earnings per share in the annual financial statements, as if the standard had been applied. Recently, a significant number of major US companies have voluntarily adopted the fair value accounting method in SFAS 123 for transactions with employees.

BC278 The FASB regards SFAS 123 as superior to APB 25, and would have preferred recognition based on the fair value of employee options to be mandatory, not optional. SFAS 123 makes it clear that the FASB decided to permit the disclosure-based alternative for political reasons, not because it thought that it was the best accounting solution:

> …the Board…continues to believe that disclosure is not an adequate substitute for recognition of assets, liabilities, equity, revenues and expenses in financial statements…The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue – not because it believes that solution is the best way to improve financial accounting and reporting. (SFAS 123, paragraphs 61 and 62)

BC279 Under US GAAP, the accounting treatment of share-based payment transactions differs, depending on whether the other party to the transaction is an employee or non-employee, and whether the entity chooses to apply SFAS 123 or APB 25 to transactions with employees. Having a choice of accounting methods is generally regarded as undesirable. Indeed, the Board recently devoted much time and effort to developing improvements to existing international standards, one of the objectives of which is to eliminate choices of accounting methods.

© Copyright

BC280 Research in the US demonstrates that choosing one accounting method over the other has a significant impact on the reported earnings of US entities. For example, research by Bear Stearns and Credit Suisse First Boston on the S&P 500 shows that, had the fair value measurement method in SFAS 123 been applied for the purposes of recognising an expense for employee stock-based compensation, the earnings of the S&P 500 companies would have been significantly lower, and that the effect is growing. The effect on reported earnings is substantial in some sectors, where companies make heavy use of share options.

BC281 The Canadian Accounting Standards Board (AcSB) recently completed its project on share-based payment. In accordance with the AcSB's policy of harmonising Canadian standards with those in the US, the AcSB initially proposed a standard that was based on US GAAP, including APB 25. After considering respondents' comments, the AcSB decided to delete the guidance drawn from APB 25. The AcSB reached this decision for various reasons, including that, in its view, the intrinsic value method is flawed. Also, incorporating the requirements of APB 25 into an accounting standard would result in preparers of financial statements incurring substantial costs for which users of financial statements would derive no benefit—entities would spend a great deal of time and effort on understanding the rules and then redesigning option plans, usually by deleting existing performance conditions, to avoid recognising an expense in respect of such plans, thereby producing no improvement in the accounting for share option plans.

BC282 The Canadian standard was initially consistent with SFAS 123. That included permitting a choice between fair value-based accounting for employee stock-based compensation expense in the income statement and disclosure of pro forma amounts in the notes to both interim and annual financial statements. However, the AcSB recently amended its standard to remove the choice between recognition and disclosure, and therefore expense recognition is mandatory for financial periods beginning on or after 1 January 2004.

BC283 Because APB 25 contains serious flaws, the Board concluded that basing an IFRS on it is unlikely to represent much, if any, improvement in financial reporting. Moreover, the perverse effects of APB 25, particularly in discouraging performance-related share option plans, may cause economic distortions. Accounting standards are intended to be neutral, not to give favourable or unfavourable accounting treatments to particular transactions to encourage or discourage entities from entering into those transactions. APB 25 fails to achieve that objective. Performance-related employee share plans are common in Europe (performance conditions are often required by law) and in other parts of the world outside the US, and investors are calling for greater use of performance conditions. Therefore, the Board concluded that introducing an accounting standard based on APB 25 would be inconsistent with its objective of developing high quality accounting standards.

BC284 That leaves SFAS 123. Comments from the FASB, in the SFAS 123 Basis for Conclusions, and from the Canadian AcSB when it developed a standard based on SFAS 123, indicate that both standard-setters regard it as inadequate, because it permits a choice between recognition and disclosure. (This issue is discussed further below.) The FASB added to its agenda in March 2003 a project to review US accounting requirements on share-based payment, including removing the disclosure alternative in SFAS 123, so that expense recognition is mandatory. The Chairman of the FASB commented:

> Recent events have served as a reminder to all of us that clear, credible and comparable financial information is essential to the health and vitality of our capital market system. In the wake of the market meltdown and corporate reporting scandals, the FASB has

> received numerous requests from individual and institutional investors, financial analysts and many others urging the Board to mandate the expensing of the compensation cost relating to employee stock options…While a number of major companies have voluntarily opted to reflect these costs as an expense in reporting their earnings, other companies continue to show these costs in the footnotes to their financial statements. In addition, a move to require an expense treatment would be consistent with the FASB's commitment to work toward convergence between U.S. and international accounting standards. In taking all of these factors into consideration, the Board concluded that it was critical that it now revisit this important subject. (FASB News Release, 12 March 2003)

BC285 During the Board's redeliberations of the proposals in ED 2, the Board worked with the FASB to achieve convergence of international and US standards, to the extent possible, bearing in mind that the FASB was at an earlier stage in its project—the FASB was developing an Exposure Draft to revise SFAS 123 whereas the IASB was finalising its IFRS. The Board concluded that, although convergence is an important objective, it would not be appropriate to delay the issue of the IFRS, because of the pressing need for a standard on share-based payment, as explained in paragraphs BC2-BC5. In any event, at the time the IASB concluded its deliberations, a substantial amount of convergence had been achieved. For example, the FASB agreed with the IASB that all share-based payment transactions should be recognised in the financial statements, measured on a fair value measurement basis, including transactions in which share options are granted to employees. Hence, the FASB agreed that the disclosure alternative in SFAS 123 should be eliminated.

BC286 The IASB and FASB also agreed that, once both boards have issued final standards on share-based payment, the two boards will consider undertaking a convergence project, with the objective of eliminating any remaining areas of divergence between international and US standards on this topic.

Recognition versus disclosure

BC287 A basic accounting concept is that disclosure of financial information is not an adequate substitute for recognition in the financial statements. For example, the *Framework* states:

> Items that meet the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material. (paragraph 82)

BC288 A key aspect of the recognition criteria is that the item can be measured with reliability. This issue is discussed further below. Therefore, this discussion focuses on the 'recognition versus disclosure' issue in principle, not on measurement reliability. Once it has been determined that an item meets the criteria for recognition in the financial statements, failing to recognise it is inconsistent with the basic concept that disclosure is not an adequate substitute for recognition.

BC289 Some disagree with this concept, arguing that it makes no difference whether information is recognised in the financial statements or disclosed in the notes. Either way, users of financial statements have the information they require to make economic decisions. Hence, they believe that note disclosure of expenses arising from particular employee share-based payment transactions (i.e. those involving awards of share options to employees), rather than recognition in the income statement, is acceptable.

© Copyright

BC290 The Board did not accept this argument. The Board noted that if note disclosure is acceptable, because it makes no difference whether the expense is recognised or disclosed, then recognition in the financial statements must also be acceptable for the same reason. If recognition is acceptable, and recognition rather than mere disclosure accords with the accounting principles applied to all other expense items, it is not acceptable to leave one particular expense item out of the income statement.

BC291 The Board also noted that there is significant evidence that there is a difference between recognition and disclosure. First, academic research indicates that whether information is recognised or merely disclosed affects market prices (e.g. Barth, Clinch and Shibano, 2003).* If information is disclosed only in the notes, users of financial statements have to expend time and effort to become sufficiently expert in accounting to know (a) that there are items that are not recognised in the financial statements, (b) that there is information about those items in the notes, and (c) how to assess the note disclosures. Because gaining that expertise comes at a cost, and not all users of financial statements will become accounting experts, information that is merely disclosed may not be fully reflected in share prices.

BC292 Second, both preparers and users of financial statements appear to agree that there is an important difference between recognition and disclosure. Users of financial statements have strongly expressed the view that all forms of share-based payment, including employee share options, should be recognised in the financial statements, resulting in the recognition of an expense when the goods or services received are consumed, and that note disclosure alone is inadequate. Their views have been expressed by various means, including:

(a) users' responses to the Discussion Paper and ED 2.

(b) the 2001 survey by the Association for Investment Management and Research of analysts and fund managers—83 per cent of survey respondents said the accounting method for all share-based payment transactions should require recognition of an expense in the income statement.

(c) public comments by users of financial statements, such as those reported in the press or made at recent US Senate hearings.

BC293 Preparers of financial statements also see a major difference between recognition and disclosure. For example, some preparers who responded to the Discussion Paper and ED 2 were concerned that unless expense recognition is required in all countries, entities that are required to recognise an expense would be at a competitive disadvantage compared with entities that are permitted a choice between recognition and disclosure. Comments such as these indicate that preparers of financial statements regard expense recognition as having consequences that are different from those of disclosure.

Reliability of measurement

BC294 One reason commonly given by those who oppose the recognition of an expense arising from transactions involving grants of share options to employees is that it is not possible to measure those transactions reliably.

* M E Barth, G Clinch and T Shibano. 2003. Market Effects of Recognition and Disclosure. *Journal of Accounting Research* 41(4): 581-609.

BC295 The Board discussed these concerns about reliability, after first putting the issue into context. For example, the Board noted that when estimating the fair value of share options, the objective is to measure that fair value at the measurement date, not the value of the underlying share at some future date. Some regard the fair value estimate as inherently uncertain because it is not known, at the measurement date, what the final outcome will be, ie how much the gain on exercise (if any) will be. However, the valuation does not attempt to estimate the future gain, only the amount that the other party would pay to obtain the right to participate in any future gains. Therefore, even if the share option expires worthless or the employee makes a large gain on exercise, this does not mean that the grant date estimate of the fair value of that option was unreliable or wrong.

BC296 The Board also noted that accounting often involves making estimates, and therefore reporting an estimated fair value is not objectionable merely because that amount represents an estimate rather than a precise measure. Examples of other estimates made in accounting, which may have a material effect on the income statement and the balance sheet, include estimates of the collectability of doubtful debts, estimates of the useful life of fixed assets and the pattern of their consumption, and estimates of employee pension liabilities.

BC297 However, some argue that including in the financial statements an estimate of the fair value of employee share options is different from including other estimates, because there is no subsequent correction of the estimate. Other estimates, such as employee pension costs, will ultimately be revised to equal the amount of the cash paid out. In contrast, because equity is not remeasured, if the estimated fair value of employee share options is recognised, there is no remeasurement of the fair value estimate—unless exercise date measurement is used—so any estimation error is permanently embedded in the financial statements.

BC298 The FASB considered and rejected this argument in developing SFAS 123. For example, for employee pension costs, the total cost is never completely trued up unless the scheme is terminated, the amount attributed to any particular year is never trued up, and it can take decades before the amounts relating to particular employees are trued up. In the meantime, users of financial statements have made economic decisions based on the estimated costs.

BC299 Moreover, the Board noted that if no expense (or an expense based on intrinsic value only, which is typically zero) is recognised in respect of employee share options, that also means that there is an error that is permanently embedded in the financial statements. Reporting zero (or an amount based on intrinsic value, if any) is never trued up.

BC300 The Board also considered the meaning of reliability. Arguments about whether estimates of the fair value of employee share options are sufficiently reliable focus on one aspect of reliability only—whether the estimate is free from material error. The *Framework*, in common with the conceptual frameworks of other accounting standard-setters, makes it clear that another important aspect of reliability is whether the information can be depended upon by users of financial statements to represent faithfully what it purports to represent. Therefore, in assessing whether a particular accounting method produces reliable financial information, it is necessary to consider whether that information is representationally faithful. This is one way in which reliability is linked to another important qualitative characteristic of financial information, relevance.

BC301 For example, in the context of share-based payment, some commentators advocate measuring employee share options at intrinsic value rather than fair value, because intrinsic value is regarded as a much more reliable measure. Whether intrinsic value is a more reliable measure is doubtful—it is certainly less subject to estimation error, but is unlikely to be a representationally faithful measure of remuneration. Nor is intrinsic value a relevant measure, especially when measured at grant date. Many employee share options are issued at the money, so have no intrinsic value at grant date. A share option with no intrinsic value consists entirely of time value. If a share option is measured at intrinsic value at grant date, zero value is attributed to the share option. Therefore, by ignoring time value, the amount attributed to the share option is 100 per cent understated.

BC302 Another qualitative characteristic is comparability. Some argue that, given the uncertainties relating to estimating the fair value of employee share options, it is better for all entities to report zero, because this will make financial statements more comparable. They argue that if, for example, for two entities the 'true' amount of expense relating to employee share options is CU500,000, and estimation uncertainties cause one entity to report CU450,000 and the other to report CU550,000, the two entities' financial statements would be more comparable if both reported zero, rather than these divergent figures.

BC303 However, it is unlikely that any two entities will have the same amount of employee share-based remuneration expense. Research (eg by Bear Stearns and Credit Suisse First Boston) indicates that the expense varies widely from industry to industry, from entity to entity, and from year to year. Reporting zero rather than an estimated amount is likely to make the financial statements much less comparable, not more comparable. For example, if the estimated employee share-based remuneration expense of Company A, Company B and Company C is CU10,000, CU100,000 and CU1,000,000 respectively, reporting zero for all three companies will not make their financial statements comparable.

BC304 In the context of the foregoing discussion of reliability, the Board addressed the question whether transactions involving share options granted to employees can be measured with sufficient reliability for the purpose of recognition in the financial statements. The Board noted that many respondents to the Discussion Paper asserted that this is not possible. They argue that option pricing models cannot be applied to employee share options, because of the differences between employee options and traded options.

BC305 The Board considered these differences, with the assistance of the project's Advisory Group and other experts, and has reached conclusions on how to take account of these differences when estimating the fair value of employee share options, as explained in paragraphs BC145-BC199. In doing so, the Board noted that the objective is to measure the fair value of the share options, i.e. an estimate of what the price of those equity instruments would have been on grant date in an arm's length transaction between knowledgeable, willing parties. The valuation methodology applied should therefore be consistent with valuation methodologies that market participants would use for pricing similar financial instruments, and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.

BC306 Hence, factors that a knowledgeable, willing market participant would not consider in setting the price of an option are not relevant when estimating the fair value of shares, share options or other equity instruments granted. For example, for share options granted to employees, factors that affect the value of the option from the individual employee's perspective only are not relevant to estimating the price that would be set

© Copyright

by a knowledgeable, willing market participant. Many respondents' comments about measurement reliability, and the differences between employee share options and traded options, often focused on the value of the option from the employee's perspective. Therefore, the Board concluded that the IFRS should emphasise that the objective is to estimate the fair value of the share option, not an employee-specific value.

BC307 The Board noted that there is evidence to support a conclusion that it is possible to make a reliable estimate of the fair value of employee share options. First, there is academic research to support this conclusion (eg Carpenter 1998, Maller, Tan and Van De Vyver 2002).[*] Second, users of financial statements regard the estimated fair values as sufficiently reliable for recognition in the financial statements. Evidence of this can be found in a variety of sources, such as the comment letters received from users of financial statements who responded to the Discussion Paper and ED 2. Users' views are important, because the objective of financial statements is to provide high quality, transparent and comparable information to help users make economic decisions. In other words, financial statements are intended to meet the needs of users, rather than preparers or other interest groups. The purpose of setting accounting standards is to ensure that, wherever possible, the information provided in the financial statements meets users' needs. Therefore, if the people who use the financial statements in making economic decisions regard the fair value estimates as sufficiently reliable for recognition in the financial statements, this provides strong evidence of measurement reliability.

BC308 The Board also noted that, although the FASB decided to permit a choice between recognition and disclosure of expenses arising from employee share-based payment transactions, it did so for non-technical reasons, not because it agreed with the view that reliable measurement was not possible:

> The Board continues to believe that use of option-pricing models, as modified in this statement, will produce estimates of the fair value of stock options that are sufficiently reliable to justify recognition in financial statements. Imprecision in those estimates does not justify failure to recognize compensation cost stemming from employee stock options. That belief underlies the Board's encouragement to entities to adopt the fair value based method of recognizing stock-based employee compensation cost in their financial statements. (SFAS 123, Basis for Conclusions, paragraph 117)

BC309 In summary, if expenses arising from grants of share options to employees are omitted from the financial statements, or recognised using the intrinsic value method (which typically results in zero expense) or the minimum value method, there will be a permanent error embedded in the financial statements. So the question is, which accounting method is more likely to produce the smallest amount of error and the most relevant, comparable information—a fair value estimate, which might result in some understatement or overstatement of the associated expense, or another measurement basis, such as intrinsic value (especially if measured at grant date), that will definitely result in substantial understatement of the associated expense?

[*] J N Carpenter. 1998. The exercise and valuation of executive stock options. *Journal of Financial Economics* 48: 127-158.
R A Maller, R Tan and M Van De Vyver. 2002. How Might Companies Value ESOs? *Australian Accounting Review* 12 (1): 11-24.

BC310 Taking all of the above into consideration, the Board concluded that, in virtually all cases, the estimated fair value of employee share options at grant date can be measured with sufficient reliability for the purposes of recognising employee share-based payment transactions in the financial statements. The Board therefore concluded that, in general, the IFRS on share-based payment should require a fair value measurement method to be applied to all types of share-based payment transactions, including all types of employee share-based payment. Hence, the Board concluded that the IFRS should not allow a choice between a fair value measurement method and an intrinsic value measurement method, and should not permit a choice between recognition and disclosure of expenses arising from employee share-based payment transactions.

Transitional provisions

Share-based payment transactions among group entities

BC310A The Board noted a potential difficulty when an entity retrospectively applies the amendments made by *Group Cash-settled Share-based Payment Transactions* issued in June 2009. An entity might not have accounted for some group share-based payment transactions in accordance with IFRS 2 in its separate or individual financial statements. In a few cases, an entity that settles a group share-based payment transaction may have to apply hindsight to measure the fair value of awards now required to be accounted for as cash-settled. However, the Board noted that such transactions would have been accounted for in accordance with IFRS 2 in the group's consolidated financial statements. For these reasons and those outlined in paragraph BC268G, if the information necessary for retrospective application is not available, the Board decided to require an entity to use amounts previously recognised in the group's consolidated financial statements when applying the new requirements retrospectively in the entity's separate or individual financial statements.

Consequential amendments to other Standards

Tax effects of share-based payment transactions

BC311 Whether expenses arising from share-based payment transactions are deductible, and if so, whether the amount of the tax deduction is the same as the reported expense and whether the tax deduction arises in the same accounting period, varies from country to country.

BC312 If the amount of the tax deduction is the same as the reported expense, but the tax deduction arises in a later accounting period, this will result in a deductible temporary difference under IAS 12 *Income Taxes*. Temporary differences usually arise from differences between the carrying amount of assets and liabilities and the amount attributed to those assets and liabilities for tax purposes. However, IAS 12 also deals with items that have a tax base but are not recognised as assets and liabilities in the balance sheet. It gives an example of research costs that are recognised as an expense in the financial statements in the period in which the costs are incurred, but are deductible for tax purposes in a later accounting period. The Standard states that the difference between the tax base of the research costs, being the amount that will be deductible in a future accounting period, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset (IAS 12, paragraph 9).

BC313 Applying this guidance indicates that if an expense arising from a share-based payment transaction is recognised in the financial statements in one accounting period and is tax-deductible in a later accounting period, this should be accounted for as a deductible temporary difference under IAS 12. Under that Standard, a deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be used (IAS 12, paragraph 24).

BC314 Whilst IAS 12 does not discuss reverse situations, the same logic applies. For example, suppose the entity is able to claim a tax deduction for the total transaction amount at the date of grant but the entity recognises an expense arising from that transaction over the vesting period. Applying the guidance in IAS 12 suggests that this should be accounted for as a taxable temporary difference, and hence a deferred tax liability should be recognised.

BC315 However, the amount of the tax deduction might differ from the amount of the expense recognised in the financial statements. For example, the measurement basis applied for accounting purposes might not be the same as that used for tax purposes, eg intrinsic value might be used for tax purposes and fair value for accounting purposes. Similarly, the measurement date might differ. For example, US entities receive a tax deduction based on intrinsic value at the date of exercise in respect of some share options, whereas for accounting purposes an entity applying SFAS 123 would recognise an expense based on the option's fair value, measured at the date of grant. There could also be other differences in the measurement method applied for accounting and tax purposes, eg differences in the treatment of forfeitures or different valuation methodologies applied.

BC316 SFAS 123 requires that, if the amount of the tax deduction exceeds the total expense recognised in the financial statements, the tax benefit for the excess deduction should be recognised as additional paid-in capital, ie as a direct credit to equity. Conversely, if the tax deduction is less than the total expense recognised for accounting purposes, the write-off of the related deferred tax asset in excess of the benefits of the tax deduction is recognised in the income statement, except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous share-based payment transactions (SFAS 123, paragraph 44).

BC317 At first sight, it may seem questionable to credit or debit directly to equity amounts that relate to differences between the amount of the tax deduction and the total recognised expense. The tax effects of any such differences would ordinarily flow through the income statement. However, some argue that the approach in SFAS 123 is appropriate if the reason for the difference between the amount of the tax deduction and the recognised expense is that a different measurement date is applied.

BC318 For example, suppose grant date measurement is used for accounting purposes and exercise date measurement is used for tax purposes. Under grant date measurement, any changes in the value of the equity instrument after grant date accrue to the employee (or other party) in their capacity as equity participants. Therefore, some argue that any tax effects arising from those valuation changes should be credited to equity (or debited to equity, if the value of the equity instrument declines).

BC319 Similarly, some argue that the tax deduction arises from an equity transaction (the exercise of options), and hence the tax effects should be reported in equity. It can also be argued that this treatment is consistent with the requirement in IAS 12 to account for the tax effects of transactions or events in the same way as the entity accounts for those transactions or events themselves. If the tax deduction relates to both an income

statement item and an equity item, the associated tax effects should be allocated between the income statement and equity.

BC320 Others disagree, arguing that the tax deduction relates to employee remuneration expense, i.e. an income statement item only, and therefore all of the tax effects of the deduction should be recognised in the income statement. The fact that the taxing authority applies a different method in measuring the amount of the tax deduction does not change this conclusion. A further argument is that this treatment is consistent with the *Framework*, because reporting amounts directly in equity would be inappropriate, given that the government is not an owner of the entity.

BC321 The Board noted that, if one accepts that it might be appropriate to debit/ credit to equity the tax effect of the difference between the amount of the tax deduction and the total recognised expense where that difference relates to changes in the value of equity interests, there could be other reasons why the amount of the tax deduction differs from the total recognised expense. For example, grant date measurement may be used for both tax and accounting purposes, but the valuation methodology used for tax purposes might produce a higher value than the methodology used for accounting purposes (eg the effects of early exercise might be ignored when valuing an option for tax purposes). The Board saw no reason why, in this situation, the excess tax benefits should be credited to equity.

BC322 In developing ED 2, the Board concluded that the tax effects of share-based payment transactions should be recognised in the income statement by being taken into account in the determination of tax expense. It agreed that this should be explained in the form of a worked example in a consequential amendment to IAS 12.

BC323 During the Board's redeliberation of the proposals in ED 2, the Board reconsidered the points above, and concluded that the tax effects of an equity-settled share-based payment transaction should be allocated between the income statement and equity. The Board then considered how this allocation should be made and related issues, such as the measurement of the deferred tax asset.

BC324 Under IAS 12, the deferred tax asset for a deductible temporary difference is based on the amount the taxation authorities will permit as a deduction in future periods. Therefore, the Board concluded that the measurement of the deferred tax asset should be based on an estimate of the future tax deduction. If changes in the share price affect that future tax deduction, the estimate of the expected future tax deduction should be based on the current share price.

BC325 These conclusions are consistent with the proposals in ED 2 concerning the measurement of the deferred tax asset. However, this approach differs from SFAS 123, which measures the deferred tax asset on the basis of the cumulative recognised expense. The Board rejected the SFAS 123 method of measuring the deferred tax asset because it is inconsistent with IAS 12. As noted above, under IAS 12, the deferred tax asset for a deductible temporary difference is based on the amount the taxation authorities will permit as a deduction in future periods. If a later measurement date is applied for tax purposes, it is very unlikely that the tax deduction will ever equal the cumulative expense, except by coincidence. For example, if share options are granted to employees, and the entity receives a tax deduction measured as the difference between the share price and the exercise price at the date of exercise, it is extremely unlikely that the tax deduction will ever equal the cumulative expense. By basing the measurement of the deferred tax asset on the cumulative expense, the SFAS 123 method is likely to result in the understatement or overstatement of the deferred tax asset. In some situations, such as when share options are significantly out of the money, SFAS 123

requires the entity to continue to recognise a deferred tax asset even when the possibility of the entity recovering that asset is remote. Continuing to recognise a deferred tax asset in this situation is not only inconsistent with IAS 12, it is inconsistent with the definition of an asset in the *Framework*, and the requirements of other IFRSs for the recognition and measurement of assets, including requirements to assess impairment.

BC326 The Board also concluded that:

(a) if the tax deduction received (or expected to be received, measured as described in paragraph BC324) is less than or equal to the cumulative expense, the associated tax benefits received (or expected to be received) should be recognised as tax income and included in profit or loss for the period.

(b) if the tax deduction received (or expected to be received, measured as described in paragraph BC324) exceeds the cumulative expense, the excess associated tax benefits received (or expected to be received) should be recognised directly in equity.

BC327 The above allocation method is similar to that applied in SFAS 123, with some exceptions. First, the above allocation method ensures that the total tax benefits recognised in the income statement in respect of a particular share-based payment transaction do not exceed the tax benefits ultimately received. The Board disagreed with the approach in SFAS 123, which sometimes results in the total tax benefits recognised in the income statement exceeding the tax benefits ultimately received because, in some situations, SFAS 123 permits the unrecovered portion of the deferred tax asset to be written off to equity.

BC328 Second, the Board concluded that the above allocation method should be applied irrespective of why the tax deduction received (or expected to be received) differs from the cumulative expense. The SFAS 123 method is based on US tax legislation, under which the excess tax benefits credited to equity (if any) arise from the use of a later measurement date for tax purposes. The Board agreed with respondents who commented that the accounting treatment must be capable of being applied in various tax jurisdictions. The Board was concerned that requiring entities to examine the reasons why there is a difference between the tax deduction and the cumulative expense, and then account for the tax effects accordingly, would be too complex to be applied consistently across a wide range of different tax jurisdictions.

BC329 The Board noted that it might need to reconsider its conclusions on accounting for the tax effects of share-based payment transactions in the future, for example, if the Board reviews IAS 12 more broadly.

Accounting for own shares held

BC330 IAS 32 requires the acquisition of treasury shares to be deducted from equity, and no gain or loss is to be recognised on the sale, issue or cancellation of treasury shares. Consideration received on the subsequent sale or issue of treasury shares is credited to equity.

© Copyright

BC331 This is consistent with the *Framework*. The repurchase of shares and their subsequent reissue or transfer to other parties are transactions with equity participants that should be recognised as changes in equity. In accounting terms, there is no difference between shares that are repurchased and cancelled, and shares that are repurchased and held by the entity. In both cases, the repurchase involves an outflow of resources to shareholders (i.e. a distribution), thereby reducing shareholders' investment in the entity. Similarly, there is no difference between a new issue of shares and an issue of shares previously repurchased and held in treasury. In both cases, there is an inflow of resources from shareholders, thereby increasing shareholders' investment in the entity. Although accounting practice in some jurisdictions treats own shares held as assets, this is not consistent with the definition of assets in the *Framework* and the conceptual frameworks of other standard-setters, as explained in the Discussion Paper (footnote to paragraph 4.7 of the Discussion Paper, reproduced earlier in the footnote to paragraph BC73).

BC332 Given that treasury shares are treated as an asset in some jurisdictions, it will be necessary to change that accounting treatment when this IFRS is applied, because otherwise an entity would be faced with two expense items—an expense arising from the share-based payment transaction (for the consumption of goods and services received as consideration for the issue of an equity instrument) and another expense arising from the write-down of the 'asset' for treasury shares issued or transferred to employees at an exercise price that is less than their purchase price.

BC333 Hence, the Board concluded that the requirements in the relevant paragraphs of IAS 32 regarding treasury shares should also be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share plans or other share-based payment arrangements.

© Copyright

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In the Basis for Conclusions on IFRS 2 the heading above paragraph BC25 is footnoted as follows:

> * In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

HKFRS 2 IG
Revised ~~July 2009~~February 2010

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

CONTENTS

paragraphs

GUIDANCE ON IMPLEMENTING IFRS 2 *SHARE-BASED PAYMENT*

DEFINITION OF GRANT DATE **IG1-IG4**

DEFINITION OF VESTING CONDITIONS **IG4A**

~~MEASUREMENT DATE FOR~~ TRANSACTIONS WITH PARTIES OTHER THAN EMPLOYEES **IG5-IG7**

TRANSITIONAL ARRANGEMENTS **IG8**

ILLUSTRATIVE EXAMPLES **IG9-IG22**

Equity-settled share-based payment transactions **IG9-IG17**
Cash-settled share-based payment transactions **IG18-IG19**
Share-based payment arrangements with cash alternatives **IG20-IG22**

ILLUSTRATIVE DISCLOSURES **IG23**

SUMMARY OF CONDITIONS FOR A COUNTERPARTY TO RECEIVE AN EQUITY INSTRUMENT GRANTED AND OF ACCOUNTING TREATMENTS **IG24**

Table of Concordance

~~APPENDIX~~

~~A Amendments to Implementation Guidance on IFRS 2~~
~~— *Group Cash-settled Share-based Payment Transactions*~~

Guidance on implementing IFRS 2 *Share-based Payment*

This guidance accompanies, but is not part of, IFRS 2.

Definition of grant date

IG1 IFRS 2 defines grant date as the date at which the entity and the employee (or other party providing similar services) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

IG2 As noted above, grant date is when both parties agree to a share-based payment arrangement. The word 'agree' is used in its usual sense, which means that there must be both an offer and acceptance of that offer. Hence, the date at which one party makes an offer to another party is not grant date. The date of grant is when that other party accepts the offer. In some instances, the counterparty explicitly agrees to the arrangement, e.g. by signing a contract. In other instances, agreement might be implicit, e.g. for many share-based payment arrangements with employees, the employees' agreement is evidenced by their commencing to render services.

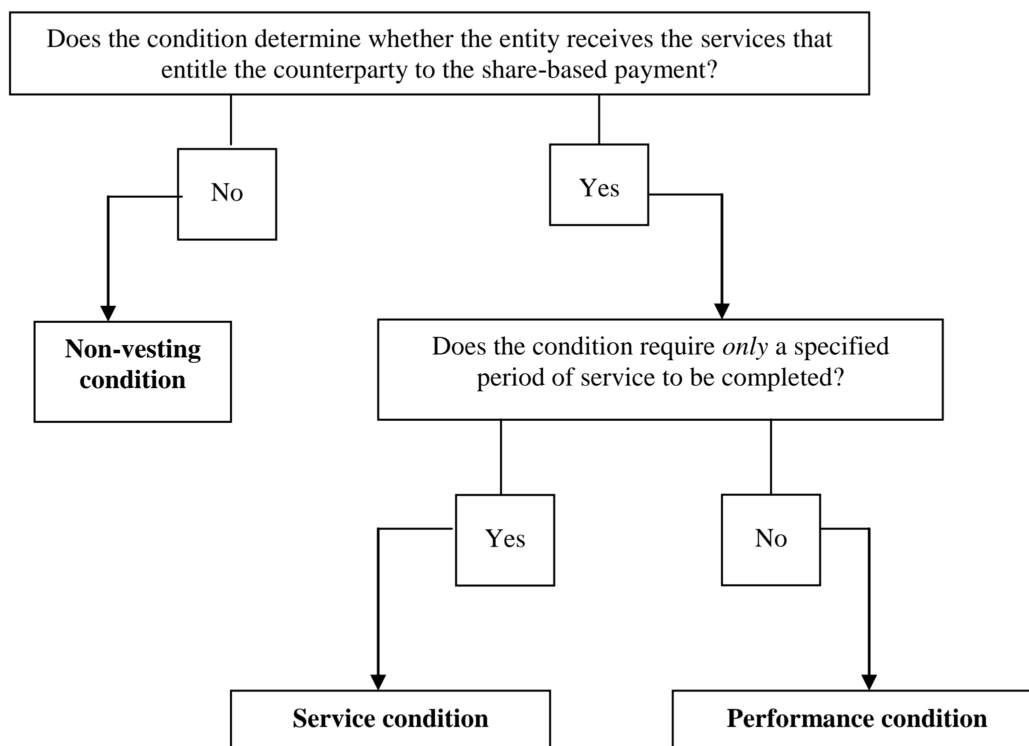
IG3 Furthermore, for both parties to have agreed to the share-based payment arrangement, both parties must have a shared understanding of the terms and conditions of the arrangement. Therefore, if some of the terms and conditions of the arrangement are agreed on one date, with the remainder of the terms and conditions agreed on a later date, then grant date is on that later date, when all of the terms and conditions have been agreed. For example, if an entity agrees to issue share options to an employee, but the exercise price of the options will be set by a compensation committee that meets in three months' time, grant date is when the exercise price is set by the compensation committee.

IG4 In some cases, grant date might occur after the employees to whom the equity instruments were granted have begun rendering services. For example, if a grant of equity instruments is subject to shareholder approval, grant date might occur some months after the employees have begun rendering services in respect of that grant. The IFRS requires the entity to recognise the services when received. In this situation, the entity should estimate the grant date fair value of the equity instruments (e.g. by estimating the fair value of the equity instruments at the end of the reporting period), for the purposes of recognising the services received during the period between service commencement date and grant date. Once the date of grant has been established, the entity should revise the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments.

© Copyright

Definition of vesting conditions

IG4A IFRS 2 defines vesting conditions as the conditions that determine 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. The following flowchart illustrates the evaluation of whether a condition is a service or performance condition or a non-vesting condition.



~~Measurement date for t~~Transactions with parties other than employees

IG5[*] For transactions with parties other than employees (and others providing similar services) that are measured by reference to the fair value of the equity instruments granted, paragraph 13 of IFRS 2 includes a rebuttable presumption that the fair value of the goods or receives received can be estimated reliably. In these situations, paragraph 13 of IFRS 2 requires the entity to measure that fair value at the date the entity obtains the goods or the counterparty renders service.

Transaction in which the entity cannot identify specifically some or all of the goods or services received

IG5A[*] In some cases, however, it might be difficult to demonstrate that goods or services have been (or will be) received. For example, an entity may grant shares to a charitable organisation for nil consideration. It is usually not possible to identify the specific goods or services received in return for such a transaction. A similar situation might arise in transactions with other parties.

[*] Amendments effective for annual period beginning on or after 1 January 2010.

IG5B* Paragraph 11 of IFRS 2 requires transactions in which share-based payments are made to employees to be measured by reference to the fair value of the share-based payments at grant date.† Hence, the entity is not required to measure directly the fair value of the employee services received.

IG5C* It should be noted that the phrase 'the fair value of the share-based payment' refers to the fair value of the particular share-based payment concerned. For example, an entity might be required by government legislation to issue some portion of its shares to nationals of a particular country that may be transferred only to other nationals of that country. Such a transfer restriction may affect the fair value of the shares concerned, and therefore those shares may have a fair value that is less than the fair value of otherwise identical shares that do not carry such restrictions. In this situation, the phrase 'the fair value of the share-based payment' would refer to the fair value of the restricted shares, not the fair value of other, unrestricted shares.

IG5D* Paragraph 13A of IFRS 2 specifies how such transactions should be measured. The following example illustrates how the entity should apply the requirements of the IFRS to a transaction in which the entity cannot identify specifically some or all of the goods or services received.

IG Example 1

Share-based payment transaction in which the entity cannot identify specifically some or all of the goods or services received

Background

An entity granted shares with a total fair value of CU100,000[(a)] to parties other than employees who are from a particular section of the community (historically disadvantaged individuals), as a means of enhancing its image as a good corporate citizen. The economic benefits derived from enhancing its corporate image could take a variety of forms, such as increasing its customer base, attracting or retaining employees, or improving or maintaining its ability to tender successfully for business contracts.

The entity cannot identify the specific consideration received. For example, no cash was received and no service conditions were imposed. Therefore, the identifiable consideration (nil) is less than the fair value of the equity instruments granted (CU100,000).

Application of requirements

Although the entity cannot identify the specific goods or services received, the circumstances indicate that goods or services have been (or will be) received, and therefore IFRS 2 applies.

In this situation, because the entity cannot identify the specific goods or services received, the rebuttable presumption in paragraph 13 of IFRS 2, that the fair value of the goods or services received can be estimated reliably, does not apply. The entity should instead measure the goods or services received by reference to the fair value of the equity instruments granted.

(a) In this example, and in all other examples in this guidance, monetary amounts are denominated in 'currency units (CU)'.

* Amendments effective for annual period beginning on or after 1 January 2010.

† In IFRS 2, all references to employees include others providing similar services.

Measurement date for transactions with parties other than employees

IG6 If the goods or services are received on more than one date, the entity should measure the fair value of the equity instruments granted on each date when goods or services are received. The entity should apply that fair value when measuring the goods or services received on that date.

IG7 However, an approximation could be used in some cases. For example, if an entity received services continuously during a three-month period, and its share price did not change significantly during that period, the entity could use the average share price during the three-month period when estimating the fair value of the equity instruments granted.

Transitional arrangements

IG8 In paragraph 54 of IFRS 2, the entity is encouraged, but not required, to apply the requirements of the IFRS to other grants of equity instruments (i.e. grants other than those specified in paragraph 53 of the IFRS), if the entity has disclosed publicly the fair value of those equity instruments, measured at the measurement date. For example, such equity instruments include equity instruments for which the entity has disclosed in the notes to its financial statements the information required in the US by SFAS 123 *Accounting for Stock-Based Compensation.*

Equity-settled share-based payment transactions

IG9 For equity-settled transactions measured by reference to the fair value of the equity instruments granted, paragraph 19 of IFRS 2 states that vesting conditions, other than market conditions,* are not taken into account when estimating the fair value of the shares or share options at the measurement date (i.e. grant date, for transactions with employees and others providing similar services). Instead, vesting conditions are 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 is 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, e.g. the counterparty fails to complete a specified service period, or a performance condition is not satisfied. This accounting method is known as the modified grant date method, because the number of equity instruments included in the determination of the transaction amount is adjusted to reflect the outcome of the vesting conditions, but no adjustment is made to the fair value of those equity instruments. That fair value is estimated at grant date (for transactions with employees and others providing similar services) and not subsequently revised. Hence, neither increases nor decreases in the fair value of the equity instruments after grant date are taken into account when determining the transaction amount (other than in the context of measuring the incremental fair value transferred if a grant of equity instruments is subsequently modified).

* In the remainder of this paragraph, the discussion of vesting conditions excludes market conditions, which are subject to the requirements of paragraph 21 of IFRS 2.

© Copyright

IG10 To apply these requirements, paragraph 20 of IFRS 2 requires the entity to recognise the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vested (subject to the requirements of paragraph 21 concerning market conditions).

IG11 In the examples below, the share options granted all vest at the same time, at the end of a specified period. In some situations, share options or other equity instruments granted might vest in instalments over the vesting period. For example, suppose an employee is granted 100 share options, which will vest in instalments of 25 share options at the end of each year over the next four years. To apply the requirements of the IFRS, the entity should treat each instalment as a separate share option grant, because each instalment has a different vesting period, and hence the fair value of each instalment will differ (because the length of the vesting period affects, for example, the likely timing of cash flows arising from the exercise of the options).

IG Example 1A

Background

An entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share option is CU15.[*]

On the basis of a weighted average probability, the entity estimates that 20 per cent of employees will leave during the three-year period and therefore forfeit their rights to the share options.

Application of requirements

Scenario 1

If everything turns out exactly as expected, the entity recognises the following amounts during the vesting period, for services received as consideration for the share options.

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	50,000 options × 80% × CU15 × 1/3 years	200,000	200,000
2	(50,000 options × 80% × CU15 × 2/3 years) – CU200,000	200,000	400,000
3	(50,000 options × 80% × CU15 × 3/3 years) – CU400,000	200,000	600,000

continued …

[*] ~~In this example, and in all other examples in this guidance, monetary amounts are denominated in ‘currency units (CU)’.~~

… continued
IG Example 1

Scenario 2

During year 1, 20 employees leave. The entity revises its estimate of total employee departures over the three-year period from 20 per cent (100 employees) to 15 per cent (75 employees). During year 2, a further 22 employees leave. The entity revises its estimate of total employee departures over the three-year period from 15 per cent to 12 per cent (60 employees). During year 3, a further 15 employees leave. Hence, a total of 57 employees forfeited their rights to the share options during the three-year period, and a total of 44,300 share options (443 employees × 100 options per employee) vested at the end of year 3.

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	50,000 options × 85% × CU15 × 1/3 years	212,500	212,500
2	(50,000 options × 88% × CU15 × 2/3 years) – CU21,250	227,500	440,000
3	(44,300 options × CU15) – CU440,000	224,500	664,500

IG12 In Example 1A, the share options were granted conditionally upon the employees' completing a specified service period. In some cases, a share option or share grant might also be conditional upon the achievement of a specified performance target. Examples 2, 3 and 4 illustrate the application of the IFRS to share option or share grants with performance conditions (other than market conditions, which are discussed in paragraph IG13 and illustrated in Examples 5 and 6). In Example 2, the length of the vesting period varies, depending on when the performance condition is satisfied. Paragraph 15 of the IFRS requires the entity to estimate the length of the expected vesting period, based on the most likely outcome of the performance condition, and to revise that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

© Copyright

IG Example 2

Grant with a performance condition, in which the length of the vesting period varies

Background

At the beginning of year 1, the entity grants 100 shares each to 500 employees, conditional upon the employees' remaining in the entity's employ during the vesting period. The shares will vest at the end of year 1 if the entity's earnings increase by more than 18 per cent; at the end of year 2 if the entity's earnings increase by more than an average of 13 per cent per year over the two-year period; and at the end of year 3 if the entity's earnings increase by more than an average of 10 per cent per year over the three-year period. The shares have a fair value of CU30 per share at the start of year 1, which equals the share price at grant date. No dividends are expected to be paid over the three-year period.

By the end of year 1, the entity's earnings have increased by 14 per cent, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that 440 employees will vest in 100 shares each at the end of year 2.

By the end of year 2, the entity's earnings have increased by only 10 per cent and therefore the shares do not vest at the end of year 2. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity's earnings will increase by at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of year 3, 23 employees have left and the entity's earnings had increased by 8 per cent, resulting in an average increase of 10.67 per cent per year. Therefore, 419 employees received 100 shares at the end of year 3.

Application of requirements

Year	Calculation	Remuneration expense for period	Cumulative remuneration Expense
		CU	CU
1	440 employees × 100 shares × CU30 × 1/2	660,000	660,000
2	(417 employees × 100 shares × CU30 × 2/3) – CU660,000	174,000	834,000
3	(419 employees × 100 shares × CU30 × 3/3) – CU834,000	423,000	1,257,000

IG Example 3

Grant with a performance condition, in which the number of equity instruments varies

Background

At the beginning of year 1, Entity A grants share options to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity's employ, and provided that the volume of sales of a particular product increases by at least an average of 5 per cent per year. If the volume of sales of the product increases by an average of between 5 per cent and 10 per cent per year, each employee will receive 100 share options. If the volume of sales increases by an average of between 10 per cent and 15 per cent each year, each employee will receive 200 share options. If the volume of sales increases by an average of 15 per cent or more, each employee will receive 300 share options.

On grant date, Entity A estimates that the share options have a fair value of CU20 per option. Entity A also estimates that the volume of sales of the product will increase by an average of between 10 per cent and 15 per cent per year, and therefore expects that, for each employee who remains in service until the end of year 3, 200 share options will vest. The entity also estimates, on the basis of a weighted average probability, that 20 per cent of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the entity still expects that a total of 20 employees will leave by the end of year 3. Hence, the entity expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12 per cent and the entity expects this rate of increase to continue over the next 2 years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The entity now expects only three more employees will leave during year 3, and therefore expects a total of 15 employees will have left during the three-year period, and hence 85 employees are expected to remain. Product sales have increased by 18 per cent, resulting in an average of 15 per cent over the two years to date. The entity now expects that sales will average 15 per cent or more over the three-year period, and hence expects each sales employee to receive 300 share options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The entity's sales have increased by an average of 16 per cent over the three years. Therefore, each of the 86 employees receives 300 share options.

Application of requirements

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	80 employees × 200 options × CU20 × 1/3	106,667	106,667
2	(85 employees × 300 options × CU20 × 2/3) – CU106,667	233,333	340,000
3	(86 employees × 300 options × CU20 × 3/3) – CU340,000	176,000	516,000

© Copyright

IG Example 4

Grant with a performance condition, in which the exercise price varies

Background

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive's remaining in the entity's employ until the end of year 3. The exercise price is CU40. However, the exercise price drops to CU30 if the entity's earnings increase by at least an average of 10 per cent per year over the three-year period.

On grant date, the entity estimates that the fair value of the share options, with an exercise price of CU30, is CU16 per option. If the exercise price is CU40, the entity estimates that the share options have a fair value of CU12 per option.

During year 1, the entity's earnings increased by 12 per cent, and the entity expects that earnings will continue to increase at this rate over the next two years. The entity therefore expects that the earnings target will be achieved, and hence the share options will have an exercise price of CU30.

During year 2, the entity's earnings increased by 13 per cent, and the entity continues to expect that the earnings target will be achieved.

During year 3, the entity's earnings increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested share options have an exercise price of CU40.

Application of requirements

Because the exercise price varies depending on the outcome of a performance condition that is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be CU40 and the possibility that the exercise price might be CU30) is not taken into account when estimating the fair value of the share options at grant date. Instead, the entity estimates the fair value of the share options at grant date under each scenario (i.e. exercise price of CU40 and exercise price of CU30) and ultimately revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	10,000 options × CU16 × 1/3	53,333	53,333
2	(10,000 options × CU16 × 2/3) – CU53,333	53,334	106,667
3	(10,000 options × CU12 × 3/3) – CU106,667	13,333	120,000

© Copyright

IG13 Paragraph 21 of the IFRS requires market conditions, such as a target share price upon which vesting (or exercisability) is conditional, to be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity recognises the goods or services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied. Example 5 illustrates these requirements.

IG Example 5

Grant with a market condition

Background

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity's employ until the end of year 3. However, the share options cannot be exercised unless the share price has increased from CU50 at the beginning of year 1 to above CU65 at the end of year 3. If the share price is above CU65 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e. by the end of year 10.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price will exceed CU65 at the end of year 3 (and hence the share options become exercisable) and the possibility that the share price will not exceed CU65 at the end of year 3 (and hence the options will be forfeited). It estimates the fair value of the share options with this market condition to be CU24 per option.

Application of requirements

Because paragraph 21 of the IFRS requires the entity to recognise the services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date. Therefore, if the entity expects the executive to complete the three-year service period, and the executive does so, the entity recognises the following amounts in years 1, 2 and 3:

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	10,000 options × CU24 × 1/3	80,000	80,000
2	(10,000 options × CU24 × 2/3) – CU80,000	80,000	160,000
3	(10,000 options × CU24) – CU160,000	80,000	240,000

As noted above, these amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2 (or year 3), the amount recognised during year 1 (and year 2) would be reversed in year 2 (or year 3). This is because the service condition, in contrast to the market condition, was not taken into account when estimating the fair value of the share options at grant date. Instead, the service condition is taken into account by adjusting the transaction amount to be based on the number of equity instruments that ultimately vest, in accordance with paragraphs 19 and 20 of the IFRS.

© Copyright

IG14 In Example 5, the outcome of the market condition did not change the length of the vesting period. However, if the length of the vesting period varies depending on when a performance condition is satisfied, paragraph 15 of the IFRS requires the entity to presume that the services to be rendered by the employees as consideration for the equity instruments granted will be received in the future, over the expected vesting period. The entity is required to 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 must be consistent with the assumptions used in estimating the fair value of the share options granted, and is not subsequently revised. Example 6 illustrates these requirements.

IG Example 6

Grant with a market condition, in which the length of the vesting period varies

Background

At the beginning of year 1, an entity grants 10,000 share options with a ten-year life to each of ten senior executives. The share options will vest and become exercisable immediately if and when the entity's share price increases from CU50 to CU70, provided that the executive remains in service until the share price target is achieved. The entity applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved.

The entity estimates that the fair value of the share options at grant date is CU25 per option. From the option pricing model, the entity determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the entity estimates that the expected vesting period is five years. The entity also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 share options (10,000 share options x 8 executives) will vest at the end of year 5.

Throughout years 1–4, the entity continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

Application of requirements

Paragraph 15 of the IFRS requires the entity to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the entity not to revise that estimate. Therefore, the entity recognises the services received from the executives over years 1–5. Hence, the transaction amount is ultimately based on 70,000 share options (10,000 share options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of five years. Therefore, the entity recognises the following amounts in years 1–5:

continued …

… continued
IG Example 6

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	80,000 options × CU25 × 1/5	400,000	400,000
2	(80,000 options × CU25 × 2/5) – CU400,000	400,000	800,000
3	(80,000 options × CU25 × 3/5) – CU800,000	400,000	1,200,000
4	(80,000 options × CU25 × 4/5) – CU1,200,000	400,000	1,600,000
5	(70,000 options × CU25) – CU1,600,000	150,000	1,750,000

IG15 Paragraphs 26–29 and B42–B44 of the IFRS set out requirements that apply if a share option is repriced (or the entity otherwise modifies the terms or conditions of a share-based payment arrangement). Examples 7–9 illustrate some of these requirements.

IG Example 7

Grant of share options that are subsequently repriced

Background

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15. On the basis of a weighted average probability, the entity estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the entity's share price has dropped, and the entity reprices its share options, and that the repriced share options vest at the end of year 3. The entity estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of year 3.

The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e. before taking into account the repricing) is CU5 and that the fair value of each repriced share option is CU8.

continued …

… continued
IG Example 7

Application of requirements

Paragraph 27 of the IFRS requires the entity to recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. If the modification increases the fair value of the equity instruments granted (e.g. by reducing the exercise price), measured immediately before and after the modification, paragraph B43(a) of Appendix B requires the entity to include the incremental fair value granted (i.e. the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the equity instruments granted. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

The incremental value is CU3 per share option (CU8 – CU5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of CU15.

The amounts recognised in years 1–3 are as follows:

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	(500 – 110) employees ×100 options × CU15 × 1/3	195,000	195,000
2	(500 – 105) employees × 100 options × (CU15 × 2/3 + CU3 × 1/2) – CU195,000	259,250	454,250
3	(500 – 103) employees × 100 options × (CU15 + CU3) – CU454,250	260,350	714,600

© Copyright

IG Example 8

Grant of share options with a vesting condition that is subsequently modified

Background

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, conditional upon the employee's remaining in the entity's employ for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is CU15 per option at the date of grant.

During year 2, the entity increases the sales target to 100,000 units. By the end of year 3, the entity has sold 55,000 units, and the share options are forfeited. Twelve members of the sales team have remained in service for the three-year period.

Application of requirements

Paragraph 20 of the IFRS requires, for a performance condition that is not a market condition, the entity to recognise the services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vested. However, paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received, measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Furthermore, paragraph B44(c) of Appendix B specifies that, if the entity modifies the vesting conditions in a manner that is not beneficial to the employee, the entity does not take the modified vesting conditions into account when applying the requirements of paragraphs 19–21 of the IFRS.

Therefore, because the modification to the performance condition made it less likely that the share options will vest, which was not beneficial to the employee, the entity takes no account of the modified performance condition when recognising the services received. Instead, it continues to recognise the services received over the three-year period based on the original vesting conditions. Hence, the entity ultimately recognises cumulative remuneration expense of CU180,000 over the three-year period (12 employees × 1,000 options × CU15).

The same result would have occurred if, instead of modifying the performance target, the entity had increased the number of years of service required for the share options to vest from three years to ten years. Because such a modification would make it less likely that the options will vest, which would not be beneficial to the employees, the entity would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service over the original three-year vesting period.

© Copyright

IG Example 9

Grant of shares, with a cash alternative subsequently added

Background

At the beginning of year 1, the entity grants 10,000 shares with a fair value of CU33 per share to a senior executive, conditional upon the completion of three years' service. By the end of year 2, the share price has dropped to CU25 per share. At that date, the entity adds a cash alternative to the grant, whereby the executive can choose whether to receive 10,000 shares or cash equal to the value of 10,000 shares on vesting date. The share price is CU22 on vesting date.

Application of requirements

Paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Therefore, the entity recognises the services received over the three-year period, based on the grant date fair value of the shares.

Furthermore, the addition of the cash alternative at the end of year 2 creates an obligation to settle in cash. In accordance with the requirements for cash-settled share-based payment transactions (paragraphs 30–33 of the IFRS), the entity recognises the liability to settle in cash at the modification date, based on the fair value of the shares at the modification date and the extent to which the specified services have been received. Furthermore, the entity remeasures 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. Therefore, the entity recognises the following amounts:

continued …

© Copyright

… continued
IG Example 9

Year	Calculation	Expense CU	Equity CU	Liability CU
1	Remuneration expense for year: 10,000 shares × CU33 × 1/3	110,000	110,000	
2	Remuneration expense for year: (10,000 shares × CU33 × 2/3) – CU110,000	110,000	110,000	
	Reclassify equity to liabilities: 10,000 shares × CU25 × 2/3		(166,667)	166,667
3	Remuneration expense for year: (10,000 shares × CU33 × 3/3) – CU220,000	110,000	26,667*	83,333*
	Adjust liability to closing fair value: (CU166,667 + CU83,333) – (CU22 × 10,000 shares)	(30,000)		(30,000)
	Total	300,000	80,000	220,000

IG15A If a share-based payment has a non-vesting condition that the counterparty can choose not to meet and the counterparty does not meet that non-vesting condition during the vesting period, paragraph 28A of the IFRS requires that event to be treated as a cancellation. Example 9A illustrates the accounting for this type of event.

IG Example 9A

Share-based payment with vesting and non-vesting conditions when the counterparty can choose whether the non-vesting condition is met

Background

An entity grants an employee the opportunity to participate in a plan in which the employee obtains share options if he agrees to save 25 per cent of his monthly salary of CU400 for a three-year period. The monthly payments are made by deduction from the employee's salary. The employee may use the accumulated savings to exercise his options at the end of three years, or take a refund of his contributions at any point during the three-year period. The estimated annual expense for the share-based payment arrangement is CU120.

After 18 months, the employee stops paying contributions to the plan and takes a refund of contributions paid to date of CU1,800.

continued…

* Allocated between liabilities and equity, to bring in the final third of the liability based on the fair value of the shares as at the date of the modification.

… continued
IG Example 9

Application of requirements

There are three components to this plan: paid salary, salary deduction paid to the savings plan and share-based payment. The entity recognises an expense in respect of each component and a corresponding increase in liability or equity as appropriate. The requirement to pay contributions to the plan is a non-vesting condition, which the employee chooses not to meet in the second year. Therefore, in accordance with paragraphs 28(b) and 28A of the IFRS, the repayment of contributions is treated as an extinguishment of the liability and the cessation of contributions in year 2 is treated as a cancellation.

YEAR 1	Expense	Cash	Liability	Equity
	CU	CU	CU	CU
Paid salary	3,600 (75% × 400 × 12)	(3,600)		
Salary deduction paid to the savings plan	1,200 (25% × 400 × 12)		(1,200)	
Share-based payment	120			(120)
Total	4,920	(3,600)	(1,200)	(120)

YEAR 2	Expense	Cash	Liability	Equity
	CU	CU	CU	CU
Paid salary	4,200 (75% × 400 × 6 + 100% × 400 × 6)	(4,200)		
Salary deduction paid to the savings plan	600 (25% × 400 × 6)		(600)	
Refund of contributions to the employee		(1,800)	1,800	
Share-based payment (acceleration of remaining expense)	240 (120 × 3 – 120)			(240)
Total	5,040	(6,000)	1,200	(240)

IG16 Paragraph 24 of the IFRS requires that, in rare cases only, in which the IFRS requires the entity to measure an equity-settled share-based payment transaction by reference to the fair value of the equity instruments granted, but the entity is unable to estimate reliably that fair value at the specified measurement date (e.g. grant date, for transactions with employees), the entity shall instead measure the transaction using an intrinsic value measurement method. Paragraph 24 also contains requirements on how to apply this method. The following example illustrates these requirements.

IG Example 10

Grant of share options that is accounted for by applying the intrinsic value method

Background

At the beginning of year 1, an entity grants 1,000 share options to 50 employees. The share options will vest at the end of year 3, provided the employees remain in service until then. The share options have a life of 10 years. The exercise price is CU60 and the entity's share price is also CU60 at the date of grant.

At the date of grant, the entity concludes that it cannot estimate reliably the fair value of the share options granted.

At the end of year 1, three employees have ceased employment and the entity estimates that a further seven employees will leave during years 2 and 3. Hence, the entity estimates that 80 per cent of the share options will vest.

Two employees leave during year 2, and the entity revises its estimate of the number of share options that it expects will vest to 86 per cent.

Two employees leave during year 3. Hence, 43,000 share options vested at the end of year 3.

The entity's share price during years 1-10, and the number of share options exercised during years 4-10, are set out below. Share options that were exercised during a particular year were all exercised at the end of that year.

Year	Share price at year-end	Number of share options exercised at year-end
1	63	0
2	65	0
3	75	0
4	88	6,000
5	100	8,000
6	90	5,000
7	96	9,000
8	105	8,000
9	108	5,000
10	115	2,000

continued…

… continued
IG Example 10

Application of requirements

In accordance with paragraph 24 of the IFRS, the entity recognises the following amounts in years 1-10.

Year	Calculation	Expense for period CU	Cumulative expense CU
1	50,000 options × 80% × (CU63 – CU60) × 1/3 years	40,000	40,000
2	50,000 options × 86% × (CU65 – CU60) × 2/3 years – CU40,000	103,333	143,333
3	43,000 options × (CU75 – CU60) – CU143,333	501,667	645,000
4	37,000 outstanding options × (CU88 – CU75) + 6,000 exercised options × (CU88 – CU75)	559,000	1,204,000
5	29,000 outstanding options × (CU100 – CU88) + 8,000 exercised options × (CU100 – CU88)	444,000	1,648,000
6	24,000 outstanding options × (CU90 – CU100) + 5,000 exercised options × (CU90 – CU100)	(290,000)	1,358,000
7	15,000 outstanding options × (CU96 – CU90) + 9,000 exercised options × (CU96 – CU90)	144,000	1,502,000
8	7,000 outstanding options × (CU105 – CU96) + 8,000 exercised options × (CU105 – CU96)	135,000	1,637,000
9	2,000 outstanding options × (CU108 – CU105) + 5,000 exercised options × (CU108 – CU105)	21,000	1,658,000
10	2,000 exercised options × (CU115 – CU108)	14,000	1,672,000

IG17 There are many different types of employee share and share option plans. The following example illustrates the application of IFRS 2 to one particular type of plan—an employee share purchase plan. Typically, an employee share purchase plan provides employees with the opportunity to purchase the entity's shares at a discounted price. The terms and conditions under which employee share purchase plans operate differ from country to country. That is to say, not only are there many different types of employee share and share options plans, there are also many different types of employee share purchase plans. Therefore, the following example illustrates the application of IFRS 2 to one specific employee share purchase plan.

IG Example 11

Employee share purchase plan

Background

An entity offers all its 1,000 employees the opportunity to participate in an employee share purchase plan. The employees have two weeks to decide whether to accept the offer. Under the terms of the plan, the employees are entitled to purchase a maximum of 100 shares each. The purchase price will be 20 per cent less than the market price of the entity's shares at the date the offer is accepted, and the purchase price must be paid immediately upon acceptance of the offer. All shares purchased must be held in trust for the employees, and cannot be sold for five years. The employee is not permitted to withdraw from the plan during that period. For example, if the employee ceases employment during the five-year period, the shares must nevertheless remain in the plan until the end of the five-year period. Any dividends paid during the five-year period will be held in trust for the employees until the end of the five-year period.

In total, 800 employees accept the offer and each employee purchases, on average, 80 shares, i.e. the employees purchase a total of 64,000 shares. The weighted-average market price of the shares at the purchase date is CU30 per share, and the weighted-average purchase price is CU24 per share.

continued…

© Copyright

… continued
IG Example 11

Application of requirements

For transactions with employees, IFRS 2 requires the transaction amount to be measured by reference to the fair value of the equity instruments granted (IFRS 2, paragraph 11). To apply this requirement, it is necessary first to determine the type of equity instrument granted to the employees. Although the plan is described as an employee share purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, share option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the entity's share price at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan.

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph B3 of IFRS 2 states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the entity should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the entity estimates that the fair value of each restricted share is CU28. In this case, the fair value of the equity instruments granted is CU4 per share (being the fair value of the restricted share of CU28 less the purchase price of CU24). Because 64,000 shares were purchased, the total fair value of the equity instruments granted is CU256,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 14 of IFRS 2, the entity should recognise an expense of CU256,000 immediately.

However, in some cases, the expense relating to an ESPP might not be material. IAS 8 *Accounting Policies, Changes in Accounting Policies and Errors* states that the accounting policies in IFRSs need not be applied when the effect of applying them is immaterial (IAS 8, paragraph 8). IAS 8 also states that an omission or misstatement of an item is material if it 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 (IAS 8, paragraph 5). Therefore, in this example, the entity should consider whether the expense of CU256,000 is material.

© Copyright

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. 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. inventory), the carrying amount of that asset is not adjusted for the effects of the liability remeasurement.

© Copyright

IG Example 12

Background

An entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employ for the next three years.

During year 1, 35 employees leave. The entity estimates that a further 60 will leave during years 2 and 3. During year 2, 40 employees leave and the entity estimates that a further 25 will leave during year 3. During year 3, 22 employees leave. At the end of year 3, 150 employees exercise their SARs, another 140 employees exercise their SARs at the end of year 4 and the remaining 113 employees exercise their SARs at the end of year 5.

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below. At the end of year 3, all SARs held by the remaining employees vest. The intrinsic values of the SARs at the date of exercise (which equal the cash paid out) at the end of years 3, 4 and 5 are also shown below.

Year	Fair value	Intrinsic value
1	CU14.40	
2	CU15.50	
3	CU18.20	CU15.00
4	CU21.40	CU20.00
5		CU25.00

Application of requirements

Year	Calculation		Expense CU	Liability CU
1	(500 – 95) employees × 100 SARs × CU14.40 × 1/3		194,400	194,400
2	(500 – 100) employees × 100 SARs × CU15.50 × 2/3 – CU194,400		218,933	413,333
3	(500 – 97 – 150) employees × 100 SARs × CU18.20 – CU413,333	47,127		460,460
	+ 150 employees × 100 SARs × CU15.00	225,000		
	Total		272,127	

continued…

… continued
IG Example 12

Year	Calculation	Expense		Liability
4	(253 – 140) employees × 100 SARs × CU21.40 – CU460,460	(218,640)		241,820
	+ 140 employees × 100 SARs × CU20.00	280,000		
	Total		61,360	
5	CU0 – CU241,820	(241,820)		0
	+ 113 employees × 100 SARs × CU25.00	282,500		
	Total		40,680	
	Total		787,500	

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.

© Copyright

IG Example 13

Background

An entity grants to an employee the right to choose either 1,000 phantom shares, i.e. a right to a cash payment equal to the value of 1,000 shares, or 1,200 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At grant date, the entity's share price is CU50 per share. At the end of years 1, 2 and 3, the share price is CU52, CU55 and CU60 respectively. The entity does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is CU48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Application of requirements

The fair value of the equity alternative is CU57,600 (1,200 shares × CU48). The fair value of the cash alternative is CU50,000 (1,000 phantom shares × CU50). Therefore, the fair value of the equity component of the compound instrument is CU7,600 (CU57,600 – CU50,000).

The entity recognises the following amounts:

Year		Expense CU	Equity CU	Liability CU
1	Liability component: (1,000 × CU52 × 1/3)	17,333		17,333
	Equity component: (CU7,600 × 1/3)	2,533	2,533	
2	Liability component: (1,000 × CU55 × 2/3) – CU17,333	19,333		19,333
	Equity component: (CU7,600 × 1/3)	2,533	2,533	

continued…

… continued
IG Example 13

3	Liability component: (1,000 × CU60) – CU36,666	23,334		23,334
	Equity component: (CU7,600 × 1/3)	2,534	2,534	
End Year 3	Scenario 1: cash of CU60,000 paid			(60,000)
	Scenario 1 totals	67,600	7,600	0
	Scenario 2: 1,200 shares issued		60,000	(60,000)
	Scenario 2 totals	67,600	67,600	0

Share-based payment transactions among group entities

IG22A Paragraphs 43A and 43B of IFRS 2 specify the accounting requirements for share-based payment transactions among group entities in the separate or individual financial statements of the entity receiving the goods or services. Example 14 illustrates the journal entries in the separate or individual financial statements for a group transaction in which a parent grants rights to its equity instruments to the employees of its subsidiary.

IG Example 14

Share-based payment transactions in which a parent grants rights to its equity instruments to the employees of its subsidiary

Background

A parent grants 200 share options to each of 100 employees of its subsidiary, conditional upon the completion of two years' service with the subsidiary. The fair value of the share options on grant date is CU30 each. At grant date, the subsidiary estimates that 80 per cent of the employees will complete the two-year service period. This estimate does not change during the vesting period. At the end of the vesting period, 81 employees complete the required two years of service. The parent does not require the subsidiary to pay for the shares needed to settle the grant of share options.

Application of requirements

As required by paragraph B53 of the IFRS, over the two-year vesting period, the subsidiary measures the services received from the employees in accordance with the requirements applicable to equity-settled share-based payment transactions. Thus, the subsidiary measures the services received from the employees on the basis of the fair value of the share options at grant date. An increase in equity is recognised as a contribution from the parent in the separate or individual financial statements of the subsidiary.

continued…

continued…
IG Example 14

The journal entries recorded by the subsidiary for each of the two years are as follows:

Year 1

Dr Remuneration expense (200 × 100 × CU30 × 0.8/2)	CU240,000	
Cr Equity (Contribution from the parent)		CU240,000

Year 2

Dr Remuneration expense (200 × 100 × CU30 × 0.81 – 240,000)	CU246,000	
Cr Equity (Contribution from the parent)		CU246,000

Illustrative disclosures

IG23 The following example illustrates the disclosure requirements in paragraphs 44-52 of the IFRS.*

Extract from the Notes to the Financial Statements of Company Z for the year ended 31 December 20X5.

Share-based Payment

During the period ended 31 December 20X5, the Company had four share-based payment arrangements, which are described below.

Type of arrangement	Senior management share option plan	General employee share option plan	Executive share plan	Senior management share appreciation cash plan
Date of grant	1 January 20X4	1 January 20X5	1 January 20X5	1 July 20X5
Number granted	50,000	75,000	50,000	25,000
Contractual life	10 years	10 years	N/A	10 years
Vesting conditions	1.5 years' service and achievement of a share price target, which was achieved.	Three years' service.	Three years' service and achievement of a target growth in earnings per share.	Three years' service and achievement of a target increase in market share.

* Note that the illustrative example is not intended to be a template or model and is therefore not exhaustive. For example, it does not illustrate the disclosure requirements in paragraphs 47(c), 48 and 49 of the IFRS.

The estimated fair value of each share option granted in the general employee share option plan is CU23.60. This was calculated by applying a binomial option pricing model. The model inputs were the share price at grant date of CU50, exercise price of CU50, expected volatility of 30 per cent, no expected dividends, contractual life of ten years, and a risk-free interest rate of 5 per cent. To allow for the effects of early exercise, it was assumed that the employees would exercise the options after vesting date when the share price was twice the exercise price. Historical volatility was 40 per cent, which includes the early years of the Company's life; the Company expects the volatility of its share price to reduce as it matures.

The estimated fair value of each share granted in the executive share plan is CU50.00, which is equal to the share price at the date of grant.

Further details of the two share option plans are as follows:

	20X4		20X5	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at start of year	0	-	45,000	CU40
Granted	50,000	CU40	75,000	CU50
Forfeited	(5,000)	CU40	(8,000)	CU46
Exercised	0	-	(4,000)	CU40
Outstanding at end of year	45,000	CU40	108,000	CU46
Exercisable at end of year	0	CU40	38,000	CU40

The weighted average share price at the date of exercise for share options exercised during the period was CU52. The options outstanding at 31 December 20X5 had an exercise price of CU40 or CU50, and a weighted average remaining contractual life of 8.64 years.

	20X4 CU	20X5 CU
Expense arising from share-based payment transactions	495,000	1,105,867
Expense arising from share and share option plans	495,000	1,007,000
Closing balance of liability for cash share appreciation plan	-	98,867
Expense arising from increase in fair value of liability for cash share appreciation plan	-	9,200

Summary of conditions for a counterparty to receive an equity instrument granted and of accounting treatments

IG24 The table below categorises, with examples, the various conditions that determine whether a counterparty receives an equity instrument granted and the accounting treatment of share-based payments with those conditions.

Summary of conditions that determine whether a counterparty receives an equity instrument granted						
	VESTING CONDITIONS			**NON-VESTING CONDITIONS**		
	Service conditions	**Performance conditions**				
		Performance conditions that are market conditions	**Other performance conditions**	**Neither the entity nor the counterparty can choose whether the condition is met**	**Counterparty can choose whether to meet the condition**	**Entity can choose whether to meet the condition**
Example conditions	Requirement to remain in service for three years	Target based on the market price of the entity's equity instruments	Target based on a successful initial public offering with a specified service requirement	Target based on a commodity index	Paying contributions towards the exercise price of a share-based payment	Continuation of the plan by the entity
Include in grant-date fair value?	No	Yes	No	Yes	Yes	Yes[(a)]
Accounting treatment if the condition is not met after the grant date and during the vesting period	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest. (paragraph 19)	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period. (paragraph 21)	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest. (paragraph 19)	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period. (paragraph 21A)	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period. (paragraph 28A)	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period. (paragraph 28A)

(a) In the calculation of the fair value of the share-based payment, the probability of continuation of the plan by the entity is assumed to be 100 per cent.

Table of Concordance

This table shows how the contents of IFRIC 8 and IFRIC 11 correspond with IFRS 2 (as amended in 2009).

IFRIC 8 paragraph	**IFRS 2 (amended) paragraph**	**IFRIC 11 paragraph**	**IFRS 2 (amended) paragraph**
1	2	1	B48
2, 3	IG5A, IG5B	2, 3	B51, B52
4	None	4–6	B46
5	IG5C	7	B49
6	2	8	B53
7, 8	2	9	B59
9	2	10	B61
9–12	13A	11	B55
13, 14	64	12, 13	64
IE1–IE4	IG Example 1	IE1–IE4	IG Example 14
BC1–BC5	BC18A–BC18D	BC1, BC2	None
BC6–BC12	BC128B–BC128H	BC3–BC18	None
BC13	None	BC19	BC268P
		BC20	None
		BC21, BC22	BC268Q, BC268R

© Copyright

HKFRS 3 (Revised)
~~Issued March 2008~~Revised February 2010

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

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

* HKFRS 3 (Revised) is applicable for annual periods beginning on or after 1 July 2009. Earlier application is permitted. HKFRS 3 (Revised) supersedes HKFRS 3 issued in 2004, as amended in 2005 and 2007.

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

SUBSEQUENT MEASUREMENT AND ACCOUNTING	**54–58**
Reacquired rights	**55**
Contingent liabilities	**56**
Indemnification assets	**57**
Contingent consideration	**58**
DISCLOSURES	**59–63**
EFFECTIVE DATE AND TRANSITION	**64–67**
Effective date	**64**
Transition	**65–67**
Income taxes	67
WITHDRAWAL OF HKFRS 3 (issued 2004)	**68**

APPENDICES

A Defined terms

B Application guidance

C Amendments to other HKFRSs

D Comparison with International Accounting Standards

E Amendments resulting from other HKFRSs

BASIS FOR CONCLUSIONS

ILLUSTRATIVE EXAMPLES

Appendix E

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs 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, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) – effective for annual periods beginning on or after 1 January 2013

C5 In HKFRS 3 *Business Combinations* (as revised in 2008), paragraphs 16, 42 and 58 are amended and paragraph 64A is added as follows:

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 ~~as a financial asset available for sale or held to maturity~~, in accordance with HKFRS 9 *Financial Instruments* and HKAS 39 *Financial Instruments: Recognition and Measurement*;

(b) designation of a derivative instrument as a hedging instrument in accordance with HKAS 39; and

(c) assessment of whether an embedded derivative should be separated from ~~the~~ a host contract outside the scope of HKFRS 9 in accordance with HKAS 39 (which is a matter of 'classification' as this HKFRS uses that term).

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.

58 ...

(b) Contingent consideration classified as an asset or a liability that:

(i) is a financial instrument and is within the scope of HKFRS 9 or HKAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with ~~that~~ HKFRS 9 or HKAS 39 as applicable.

(ii) is not within the scope of HKFRS 9 or HKAS 39 shall be accounted for in accordance with HKAS 37 or other HKFRSs as appropriate.

64A HKFRS 9, issued in November 2009, amended paragraphs 16, 42 and 58. An entity shall apply those amendments when it applies HKFRS 9.

HKFRS 3 (Revised) BC
~~Issued March 2008~~Revised February 2010

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

Disclosure of information about intangible assets other than goodwill BC407

Other disclosure requirements BC408–BC409

Disclosures in interim financial information BC410

Disclosure requirements of IFRS 3 BC411–BC418

Disclosure requirements of the revised standards BC419–BC422

Disclosure of information about post-combination revenue and profit or loss of the acquiree BC423–BC428

EFFECTIVE DATE AND TRANSITION BC429–BC434

Effective date and transition for combinations of mutual entities or by contract alone BC433–BC434

BENEFITS AND COSTS BC435–BC439

DISSENTING OPINIONS ON IFRS 3

APPENDI~~X~~CES

A Amendments to the Basis for Conclusions on other HKFRSs

B Amendments resulting from other Basis for Conclusions

Appendix A
Amendments to the Basis for Conclusions on other HKFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs accompanying the equivalent converged HKFRSs that are necessary in order to ensure consistency with IFRS 3 (as revised in 2008) and the related amendments to other IFRSs. 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 text of the relevant Basis for Conclusions.

Appendix B
Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In paragraph BC185, the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' and in paragraphs BC256 and BC437(c), the references to 'IAS 39' are footnoted as follows:

> * In November 2009 the IASB amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39. This paragraph discusses matters relevant when IFRS 3 was issued.

In paragraph BC244 the reference to 'IAS 39' is footnoted as follows:

> * In November 2009 the IASB relocated to IFRS 9 *Financial Instruments* the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.

HKFRS 3 (Revised) IE and US GAAP Comparison
Issued March 2008

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

CONTENTS

paragraphs

IFRS 3 *BUSINESS COMBINATIONS*

ILLUSTRATIVE EXAMPLES

REVERSE ACQUISITIONS	**IE1–IE15**
Calculating the fair value of the consideration transferred	**IE4–IE5**
Measuring goodwill	**IE6**
Consolidated statement of financial position at 30 September 20X6	**IE7–IE8**
Earnings per share	**IE9–IE10**
Non-controlling interest	**IE11–IE15**
IDENTIFIABLE INTANGIBLE ASSETS	**IE16–IE44**
Marketing-related intangible assets	**IE18–IE22**
Customer-related intangible assets	**IE23–IE31**
Artistic-related intangible assets	**IE32–IE33**
Contract-based intangible assets	**IE34–IE38**
Technology-based intangible assets	**IE39–IE44**
GAIN ON A BARGAIN PURCHASE	**IE45–IE49**
MEASUREMENT PERIOD	**IE50–IE53**
DETERMINING WHAT IS PART OF THE BUSINESS COMBINATION TRANSACTION	**IE54–IE71**
Settlement of a pre-existing relationship	**IE54–IE57**
Contingent payments to employees	**IE58–IE60**
Replacement awards	**IE61–IE71**
DISCLOSURE REQUIREMENTS	**IE72**
APPENDIX **Amendments to guidance on other IFRSs**	
	Pages
COMPARISON OF IFRS 3 (AS REVISED IN 2008) AND SFAS 141(R)	**22–34**
TABLE OF CONCORDANCE	**35–36**

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	**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

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.

(b) The fair value of each ordinary share of Entity B at 30 September 20X6 is CU40. The quoted market price of Entity A's ordinary shares at that date is CU16.

(c) The fair values of Entity A's identifiable assets and liabilities at 30 September 20X6 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 30 September 20X6 is CU1,500.

Calculating the fair value of the consideration transferred

IE4 As a result of Entity A (legal parent, accounting acquiree) issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (ie 150 of 250 issued shares). The remaining 40 per cent are owned by Entity A's shareholders. If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B—60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is CU1,600 (40 shares with a fair value per share of CU40).

IE5 The fair value of the consideration effectively transferred should be based on the most reliable measure. In this example, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares—100 shares with a fair value per share of CU16.

Measuring goodwill

IE6 Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

	CU	CU
Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated statement of financial position at 30 September 20X6

IE7 The consolidated statement of financial position immediately after the business combination is:

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
Total liabilities	2,400
Shareholders' equity	
Retained earnings	1,400
Issued equity	
250 ordinary shares [CU600 + CU1,600]	2,200
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

IE8 The amount recognised as issued equity interests in the consolidated financial statements (CU2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (CU600) and the fair value of the consideration effectively transferred (CU1,600). However, the equity structure appearing in the consolidated financial statements (ie the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

Earnings per share

IE9 Assume that Entity B's earnings for the annual period ended 31 December 20X5 were CU600 and that the consolidated earnings for the annual period ended 31 December 20X6 were CU800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31 December 20X5 and during the period from 1 January 20X6 to the date of the reverse acquisition on 30 September 20X6. Earnings per share for the annual period ended 31 December 20X6 is calculated as follows:

Number of shares deemed to be outstanding for the period from 1 January 20X6 to the acquisition date (ie the number of ordinary shares issued by Entity A (legal parent, accounting acquiree) in the reverse acquisition)	150
Number of shares outstanding from the acquisition date to 31 December 20X6	250
Weighted average number of ordinary shares outstanding [(150 x 9/12) + (250 x 3/12)]	175
Earnings per share [800/175]	CU4.57

IE10 Restated earnings per share for the annual period ended 31 December 20X5 is CU4.00 (calculated as the earnings of Entity B of 600 divided by the number of ordinary shares Entity A issued in the reverse acquisition (150)).

Non-controlling interest

IE11 Assume the same facts as above, except that only 56 of Entity B's 60 ordinary shares are exchanged. Because Entity A issues 2.5 shares in exchange for each ordinary share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3 per cent of the issued shares of the combined entity (140 of 240 issued shares). The fair value of the consideration transferred for Entity A, the accounting acquiree, is calculated by assuming that the combination had been effected by Entity B issuing additional ordinary shares to the shareholders of Entity A in exchange for their ordinary shares in Entity A. That is because Entity A is the accounting acquirer, and paragraphs 37 and 38 of IFRS 3 requires the acquirer to measure the consideration exchanged for the accounting acquiree.

IE12 In calculating the number of shares that Entity B would have had to issue, the non-controlling interest is excluded from the calculation. The majority shareholders own 56 shares of Entity B. For that to represent a 58.3 per cent equity interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 of the 96 issued shares of Entity B and, therefore, 58.3 per cent of the combined entity. As a result, the fair value of the consideration transferred for Entity A, the accounting acquiree, is CU1,600 (ie 40 shares, each with a fair value of CU40). That is the same amount as when all 60 of Entity B's shareholders tender all 60 of its ordinary shares for exchange. The recognised amount of the group's interest in Entity A, the accounting acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.

IE13 The non-controlling interest is represented by the four shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the non-controlling interest is 6.7 per cent. The non-controlling interest reflects the proportionate interest of the non-controlling shareholders in the pre-combination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated statement of financial position is adjusted to show a non-controlling interest of 6.7 per cent of the pre-combination carrying amounts of Entity B's net assets (ie CU134 or 6.7 per cent of CU2,000).

IE14 The consolidated statement of financial position at 30 September 20X6, reflecting the non-controlling interest is as follows:

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
Total liabilities	2,400

Shareholders' equity	
Retained earnings [CU1,400 x 93.3 per cent]	1,306
Issued equity	
240 ordinary shares [CU560 + CU1,600]	2,160
Non-controlling interest	134
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

IE15 The non-controlling interest of CU134 has two components. The first component is the reclassification of the non-controlling interest's share of the accounting acquirer's retained earnings immediately before the acquisition (CU1,400 × 6.7 per cent or CU93.80). The second component represents the reclassification of the non-controlling interest's share of the accounting acquirer's issued equity (CU600 × 6.7 per cent or CU40.20).

Identifiable intangible assets

Illustrating the consequences of applying paragraphs 10–14 and B31–B40 of IFRS 3.

IE16 The following are examples of identifiable intangible assets acquired in a business combination. Some of the examples may have characteristics of assets other than intangible assets. The acquirer should account for those assets in accordance with their substance. The examples are not intended to be all-inclusive.

IE17 Intangible assets identified as having a contractual basis are those that arise from contractual or other legal rights. Those designated as having a non-contractual basis do not arise from contractual or other legal rights but are separable. Intangible assets identified as having a contractual basis might also be separable but separability is not a necessary condition for an asset to meet the contractual-legal criterion.

Marketing-related intangible assets

IE18 Marketing-related intangible assets are used primarily in the marketing or promotion of products or services. Examples of marketing-related intangible assets are:

Class	Basis
Trademarks, trade names, service marks, collective marks and certification marks	Contractual
Trade dress (unique colour, shape or package design)	Contractual
Newspaper mastheads	Contractual
Internet domain names	Contractual
Non-competition agreements	Contractual

Trademarks, trade names, service marks, collective marks and certification marks

IE19 Trademarks are words, names, symbols or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks identify the goods or services of members of a group. Certification marks certify the geographical origin or other characteristics of a good or service.

IE20 Trademarks, trade names, service marks, collective marks and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce or by other means. If it is protected legally through registration or other means, a trademark or other mark acquired in a business combination is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired in a business combination can be recognised separately from goodwill if the separability criterion is met, which normally it would be.

IE21 The terms *brand* and *brand name*, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise. IFRS 3 does not preclude an entity from recognising, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

Internet domain names

IE22 An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination meets the contractual-legal criterion.

Customer-related intangible assets

IE23 Examples of customer-related intangible assets are:

Class	Basis
Customer lists	Non-contractual
Order or production backlog	Contractual
Customer contracts and related customer relationships	Contractual
Non-contractual customer relationships	Non-contractual

Customer lists

IE24 A customer list consists of information about customers, such as their names and contact information. A customer list also may be in the form of a database that includes other information about the customers, such as their order histories and demographic information. A customer list does not usually arise from contractual or other legal rights. However, customer lists are often leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion.

Order or production backlog

IE25 An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders can be cancelled.

Customer contracts and the related customer relationships

IE26 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

IE27 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

IE28 A customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships may also arise through means other than contracts, such as through regular contact by sales or service representatives.

IE29 As noted in paragraph IE25, an order or a production backlog arises from contracts such as purchase or sales orders and is therefore considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

Examples

IE30 The following examples illustrate the recognition of customer contract and customer relationship intangible assets acquired in a business combination.

(a) Acquirer Company (AC) acquires Target Company (TC) in a business combination on 31 December 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable.

The agreement, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC's customer relationship with Customer meet the contractual-legal criterion.

(b) AC acquires TC in a business combination on 31 December 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC's relationship with Customer related to both sporting goods and electronics. However, if AC determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, AC would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

(c) AC acquires TC in a business combination on 31 December 20X5. TC does business with its customers solely through purchase and sales orders. At 31 December 20X5, TC has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of TC's customers are also recurring customers. However, as of 31 December 20X5, TC has no open purchase orders or other contracts with those customers.

Regardless of whether they are cancellable or not, the purchase orders from 60 per cent of TC's customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 per cent of its customers through contracts, not only the purchase orders but also TC's customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at 31 December 20X5.

(d) AC acquires TC, an insurer, in a business combination on 31 December 20X5. TC has a portfolio of one-year motor insurance contracts that are cancellable by policyholders.

Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

Non-contractual customer relationships

IE31 A customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same asset or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of non-contractual customer relationship would provide evidence that the relationship is separable.

Artistic-related intangible assets

IE32 Examples of artistic-related intangible assets are:

Class	Basis
Plays, operas and ballets	Contractual
Books, magazines, newspapers and other literary works	Contractual
Musical works such as compositions, song lyrics and advertising jingles	Contractual
Pictures and photographs	Contractual
Video and audiovisual material, including motion pictures or films, music videos and television programmes	Contractual

IE33 Artistic-related assets acquired in a business combination are identifiable if they arise from contractual or legal rights such as those provided by copyright. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. An acquirer is not precluded from recognising a copyright intangible asset and any related assignments or licence agreements as a single asset, provided they have similar useful lives.

Contract-based intangible assets

IE34 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible asset. If the terms of a contract give rise to a liability (for example, if the terms of an operating lease or customer contract are unfavourable relative to market terms), the acquirer recognises it as a liability assumed in the business combination. Examples of contract-based intangible assets are:

Class	Basis
Licensing, royalty and standstill agreements	Contractual
Advertising, construction, management, service or supply contracts	Contractual
Lease agreements (whether the acquiree is the lessee or the lessor)	Contractual
Construction permits	Contractual
Franchise agreements	Contractual
Operating and broadcast rights	Contractual
Servicing contracts, such as mortgage servicing contracts	Contractual
Employment contracts	Contractual
Use rights, such as drilling, water, air, timber cutting and route authorities	Contractual

Servicing contracts, such as mortgage servicing contracts

IE35 Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset (or liability) by one of the following:

(a) when contractually separated from the underlying financial asset by sale or securitisation of the assets with servicing retained;

(b) through the separate purchase and assumption of the servicing.

IE36 If mortgage loans, credit card receivables or other financial assets are acquired in a business combination with servicing retained, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.

Employment contracts

IE37 Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is favourable relative to market terms are one type of contract-based intangible asset.

Use rights

IE38 Use rights include rights for drilling, water, air, timber cutting and route authorities. Some use rights are contract-based intangible assets to be accounted for separately from goodwill. Other use rights may have characteristics of tangible assets rather than of intangible assets. An acquirer should account for use rights on the basis of their nature.

Technology-based intangible assets

IE39 Examples of technology-based intangible assets are:

Class	Basis
Patented technology	Contractual
Computer software and mask works	Contractual
Unpatented technology	Non-contractual
Databases, including title plants	Non-contractual
Trade secrets, such as secret formulas, processes and recipes	Contractual

Computer software and mask works

IE40 Computer software and program formats acquired in a business combination that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets.

IE41 Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may have legal protection. Mask works with legal protection that are acquired in a business combination meet the contractual-legal criterion for identification as intangible assets.

Databases, including title plants

IE42 Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. A database acquired in a business combination and protected by copyright meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity's normal operations, such as customer lists, or specialised information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in a business combination meets the separability criterion.

IE43 Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired in a business combination meet the separability criterion.

Trade secrets, such as secret formulas, processes and recipes

IE44 A trade secret is 'information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (a) derives independent economic value, actual or potential, from not being generally known and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.'[*] If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination are identifiable only if the separability criterion is met, which is likely to be the case.

Gain on a bargain purchase

Illustrating the consequences of recognising and measuring a gain from a bargain purchase by applying paragraphs 32–36 of IFRS 3.

IE45 The following example illustrates the accounting for a business combination in which a gain on a bargain purchase is recognised.

IE46 On 1 January 20X5 AC acquires 80 per cent of the equity interests of TC, a private entity, in exchange for cash of CU150. Because the former owners of TC needed to dispose of their investments in TC by a specified date, they did not have sufficient time to market TC to multiple potential buyers. The management of AC initially measures the separately recognisable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of IFRS 3. The identifiable assets are measured at CU250 and the liabilities assumed are measured at CU50. AC engages an independent consultant, who determines that the fair value of the 20 per cent non-controlling interest in TC is CU42.

[*] Melvin Simensky and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1998), page 293.

IE47 The amount of TC's identifiable net assets (CU200, calculated as CU250–CU50) exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in TC. Therefore, AC reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest in TC and the consideration transferred. After that review, AC decides that the procedures and resulting measures were appropriate. AC measures the gain on its purchase of the 80 per cent interest as follows:

		CU
Amount of the identifiable net assets acquired (CU250 - CU50)		200
Less: Fair value of the consideration transferred for AC's 80 per cent interest in TC; plus	150	
Fair value of non-controlling interest in TC	42	
		192
Gain on bargain purchase of 80 per cent interest		8

IE48 AC would record its acquisition of TC in its consolidated financial statements as follows:

	CU	CU
Dr Identifiable assets acquired	250	
Cr Cash		150
Cr Liabilities assumed		50
Cr Gain on the bargain purchase		8
Cr Equity—non-controlling interest in TC		42

IE49 If the acquirer chose to measure the non-controlling interest in TC on the basis of its proportionate interest in the identifiable net assets of the acquiree, the recognised amount of the non-controlling interest would be CU40 (CU200 × 0.20). The gain on the bargain purchase then would be CU10 (CU200 – (CU150 + CU40)).

Measurement period

Illustrating the consequences of applying paragraphs 45–50 of IFRS 3.

IE50 If the initial accounting for a business combination is not complete at the end of the financial reporting period in which the combination occurs, paragraph 45 of IFRS 3 requires the acquirer to recognise in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer recognises adjustments to the provisional amounts needed 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. Paragraph 49 of IFRS 3 requires the acquirer to recognise such adjustments as if the accounting for the business combination had been completed at the acquisition date. Measurement period adjustments are not included in profit or loss.

IE51 Suppose that AC acquires TC on 30 September 20X7. AC seeks an independent valuation for an item of property, plant and equipment acquired in the combination, and the valuation was not complete by the time AC authorised for issue its financial statements for the year ended 31 December 20X7. In its 20X7 annual financial statements, AC recognised a provisional fair value for the asset of CU30,000. At the acquisition date, the item of property, plant and equipment had a remaining useful life of five years. Five months after

the acquisition date, AC received the independent valuation, which estimated the asset's acquisition-date fair value as CU40,000.

IE52 In its financial statements for the year ended 31 December 20X8, AC retrospectively adjusts the 20X7 prior year information as follows:

(a) The carrying amount of property, plant and equipment as of 31 December 20X7 is increased by CU9,500. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000 less the additional depreciation that would have been recognised if the asset's fair value at the acquisition date had been recognised from that date (CU500 for three months' depreciation).

(b) The carrying amount of goodwill as of 31 December 20X7 is decreased by CU10,000.

(c) Depreciation expense for 20X7 is increased by CU500.

IE53 In accordance with paragraph B67 of IFRS 3, AC discloses:

(a) in its 20X7 financial statements, that the initial accounting for the business combination has not been completed because the valuation of property, plant and equipment has not yet been received.

(b) in its 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period. Therefore, AC discloses that the 20X7 comparative information is adjusted retrospectively to increase the fair value of the item of property, plant and equipment at the acquisition date by CU9,500, offset by a decrease to goodwill of CU10,000 and an increase in depreciation expense of CU500.

Determining what is part of the business combination transaction

Settlement of a pre-existing relationship

Illustrating the consequences of applying paragraphs 51, 52 and B50–B53 of IFRS 3.

IE54 AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than the rates at which AC could purchase similar electronic components from another supplier. The supply contract allows AC to terminate the contract before the end of the initial five-year term but only by paying a CU6 million penalty. With three years remaining under the supply contract, AC pays CU50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.

IE55 Included in the total fair value of TC is CU8 million related to the fair value of the supply contract with AC. The CU8 million represents a CU3 million component that is 'at market' because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships and so on) and a CU5 million component for pricing that is unfavourable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognised any assets or liabilities related to the supply contract before the business combination.

IE56 In this example, AC calculates a loss of CU5 million (the lesser of the CU6 million stated settlement amount and the amount by which the contract is unfavourable to the acquirer) separately from the business combination. The CU3 million 'at-market' component of the contract is part of goodwill.

IE57 Whether AC had recognised previously an amount in its financial statements related to a pre-existing relationship will affect the amount recognised as a gain or loss for the effective settlement of the relationship. Suppose that IFRSs had required AC to recognise a CU6 million liability for the supply contract before the business combination. In that situation, AC recognises a CU1 million settlement gain on the contract in profit or loss at the acquisition date (the CU5 million measured loss on the contract less the CU6 million loss previously recognised). In other words, AC has in effect settled a recognised liability of CU6 million for CU5 million, resulting in a gain of CU1 million.

Contingent payments to employees

Illustrating the consequences of applying paragraphs 51, 52, B50, B54 and B55 of IFRS 3.

IE58 TC appointed a candidate as its new CEO under a ten-year contract. The contract required TC to pay the candidate CU5 million if TC is acquired before the contract expires. AC acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

IE59 In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay CU5 million is included in the application of the acquisition method.

IE60 In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method.

Replacement awards

Illustrating the consequences of applying paragraphs 51, 52 and B56–B62 of IFRS 3.

IE61 The following examples illustrate replacement awards that the acquirer was obliged to issue in the following circumstances:

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">Acquiree awards
Has the vesting period been completed before the business combination?</td></tr>
<tr><td>Completed</td><td>Not completed</td></tr>
<tr><td rowspan="2">Replacement awards
Are employees required to provide additional service after the acquisition date?</td><td>Not required</td><td>Example 1</td><td>Example 4</td></tr>
<tr><td>Required</td><td>Example 2</td><td>Example 3</td></tr>
</table>

IE62 The examples assume that all awards are classified as equity.

Example 1

Acquiree awards	*Vesting period **completed** before the business combination*
Replacement awards	*Additional employee services **are not** required after the acquisition date*

IE63 AC issues replacement awards of CU110 (market-based measure) at the acquisition date for TC awards of CU100 (market-based measure) at the acquisition date. No post-combination services are required for the replacement awards and TC's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

IE64 The amount attributable to pre-combination service is the market-based measure of TC's awards (CU100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to post-combination service is CU10, which is the difference between the total value of the replacement awards (CU110) and the portion attributable to pre-combination service (CU100). Because no post-combination service is required for the replacement awards, AC immediately recognises CU10 as remuneration cost in its post-combination financial statements.

Example 2

Acquiree awards	*Vesting period **completed** before the business combination*
Replacement awards	*Additional employee services **are** required after the acquisition date*

IE65 AC exchanges replacement awards that require one year of post-combination service for share-based payment awards of TC, for which employees had completed the vesting period before the business combination. The market-based measure of both awards is CU100 at the acquisition date. When originally granted, TC's awards had a vesting period of four years. As of the acquisition date, the TC employees holding unexercised awards had rendered a total of seven years of service since the grant date.

IE66 Even though TC employees had already rendered all of the service, AC attributes a portion of the replacement award to post-combination remuneration cost in accordance with paragraph B59 of IFRS 3, because the replacement awards require one year of post-combination service. The total vesting period is five years—the vesting period for the original acquiree award completed before the acquisition date (four years) plus the vesting period for the replacement award (one year).

IE67 The portion attributable to pre-combination services equals the market-based measure of the acquiree award (CU100) multiplied by the ratio of the pre-combination vesting period (four years) to the total vesting period (five years). Thus, CU80 (CU100 x 4/5 years) is attributed to the pre-combination vesting period and therefore included in the consideration transferred in the business combination. The remaining CU20 is attributed to the post-combination vesting period and is therefore recognised as remuneration cost in AC's post-combination financial statements in accordance with IFRS 2.

Example 3

Acquiree awards	*Vesting period* ***not completed*** *before the business combination*
Replacement awards	*Additional employee services* ***are*** *required after the acquisition date*

IE68 AC exchanges replacement awards that require one year of post-combination service for share-based payment awards of TC, for which employees had not yet rendered all of the service as of the acquisition date. The market-based measure of both awards is CU100 at the acquisition date. When originally granted, the awards of TC had a vesting period of four years. As of the acquisition date, the TC employees had rendered two years' service, and they would have been required to render two additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of the TC awards is attributable to pre-combination service.

IE69 The replacement awards require only one year of post-combination service. Because employees have already rendered two years of service, the total vesting period is three years. The portion attributable to pre-combination services equals the market-based measure of the acquiree award (CU100) multiplied by the ratio of the pre-combination vesting period (two years) to the **greater of** the total vesting period (three years) or the original vesting period of TC's award (four years). Thus, CU50 (CU100 × 2/4 years) is attributable to pre-combination service and therefore included in the consideration transferred for the acquiree. The remaining CU50 is attributable to post-combination service and therefore recognised as remuneration cost in AC's post-combination financial statements.

Example 4

Acquiree awards	*Vesting period* ***not completed*** *before the business combination*
Replacement awards	*Additional employee services* ***are not*** *required after the acquisition date*

IE70 Assume the same facts as in Example 3 above, except that AC exchanges replacement awards that require no post-combination service for share-based payment awards of TC for which employees had not yet rendered all of the service as of the acquisition date. The terms of the replaced TC awards did not eliminate any remaining vesting period upon a change in control. (If the TC awards had included a provision that eliminated any remaining vesting period upon a change in control, the guidance in Example 1 would apply.) The market-based measure of both awards is CU100. Because employees have already rendered two years of service and the replacement awards do not require any post-combination service, the total vesting period is two years.

IE71 The portion of the market-based measure of the replacement awards attributable to pre-combination services equals the market-based measure of the acquiree award (CU100) multiplied by the ratio of the pre-combination vesting period (two years) to the **greater of** the total vesting period (two years) or the original vesting period of TC's award (four years). Thus, CU50 (CU100 × 2/4 years) is attributable to pre-combination service and therefore included in the consideration transferred for the acquiree. The remaining CU50 is attributable to post-combination service. Because no post-combination service is required to vest in the replacement award, AC recognises the entire CU50 immediately as remuneration cost in the post-combination financial statements.

Disclosure requirements

Illustrating the consequences of applying the disclosure requirements in paragraphs 59–63 and B64–B67 of IFRS 3.

IE72 The following example illustrates some of the disclosure requirements of IFRS 3; it is not based on an actual transaction. The example assumes that AC is a listed entity and that TC is an unlisted entity. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual footnote might present many of the disclosures illustrated in a simple narrative format.

Footnote X: Acquisitions

Paragraph reference

B64(a–d) On 30 June 20X0 AC acquired 15 per cent of the outstanding ordinary shares of TC. On 30 June 20X2 AC acquired 60 per cent of the outstanding ordinary shares of TC and obtained control of TC. TC is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, AC is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.

B64(e) The goodwill of CU2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of AC and TC.

B64(k) None of the goodwill recognised is expected to be deductible for income tax purposes. The following table summarises the consideration paid for TC and the amounts of the assets acquired and liabilities assumed recognised at the acquisition date, as well as the fair value at the acquisition date of the non-controlling interest in TC.

At 30 June 20X2

	Consideration	**CU**
B64(f)(i)	Cash	5,000
B64(f)(iv)	Equity instruments (100,000 ordinary shares of AC)	4,000
B64(f)(iii); B64(g)(i)	Contingent consideration arrangement	1,000
B64(f)	**Total consideration transferred**	10,000
B64(p)(i)	**Fair value of AC's equity interest in TC held before the business combination**	2,000
		12,000
B64(m)	**Acquisition-related costs** (included in selling, general and administrative expenses in AC's statement of comprehensive income for the year ended 31 December 20X2)	1,250

B64(i)	**Recognised amounts of identifiable assets acquired and liabilities assumed**	
	Financial assets	3,500
	Inventory	1,000
	Property, plant and equipment	10,000
	Identifiable intangible assets	3,300
	Financial liabilities	(4,000)
	Contingent liability	(1,000)
	Total identifiable net assets	12,800
B64(o)(i)	**Non-controlling interest in TC**	(3,300)
	Goodwill	2,500
		12,000

B64(f)(iv) The fair value of the 100,000 ordinary shares issued as part of the consideration paid for TC (CU4,000) was determined on the basis of the closing market price of AC's ordinary shares on the acquisition date.

B64(f)(iii)
B64(g)
B67(b) The contingent consideration arrangement requires AC to pay the former owners of TC 5 per cent of the revenues of XC, an unconsolidated equity investment owned by TC, in excess of CU7,500 for 20X3, up to a maximum amount of CU2,500 (undiscounted).

The potential undiscounted amount of all future payments that AC could be required to make under the contingent consideration arrangement is between CU0 and CU2,500.

The fair value of the contingent consideration arrangement of CU1,000 was estimated by applying the income approach. The fair value estimates are based on an assumed discount rate range of 20–25 per cent and assumed probability-adjusted revenues in XC of CU10,000–20,000.

As of 31 December 20X2, neither the amount recognised for the contingent consideration arrangement, nor the range of outcomes or the assumptions used to develop the estimates had changed.

B64(h) The fair value of the financial assets acquired includes receivables under finance leases of data networking equipment with a fair value of CU2,375. The gross amount due under the contracts is CU3,100, of which CU450 is expected to be uncollectible.

B67(a) The fair value of the acquired identifiable intangible assets of CU3,300 is provisional pending receipt of the final valuations for those assets.

B64(j) B67(c) IAS 37.84, 85 A contingent liability of CU1,000 has been recognised for expected warranty claims on products sold by TC during the last three years. We expect that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between CU500 and CU1,500. As of 31 December 20X2, there has been no change since 30 June 20X2 in the amount recognised for the liability or any change in the range of outcomes or assumptions used to develop the estimates.

B64(o) The fair value of the non-controlling interest in TC, an unlisted company, was estimated by applying a market approach and an income approach. The fair value estimates are based on:

(a) an assumed discount rate range of 20–25 per cent;

(b) an assumed terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long–term sustainable growth rates ranging from 3 to 6 per cent);

(c) assumed financial multiples of companies deemed to be similar to TC; and

(d) assumed adjustments because of the lack of control or lack of marketability that market participants would consider when estimating the fair value of the non-controlling interest in TC.

B64(p)(ii) AC recognised a gain of CU500 as a result of measuring at fair value its 15 per cent equity interest in TC held before the business combination. The gain is included in other income in AC’s statement of comprehensive income for the year ending 31 December 20X2.

B64(q)(i) The revenue included in the consolidated statement of comprehensive income since 30 June 20X2 contributed by TC was CU4,090. TC also contributed profit of CU1,710 over the same period.

B64(q)(ii) Had TC been consolidated from 1 January 20X2 the consolidated statement of comprehensive income would have included revenue of CU27,670 and profit of CU12,870.

Appendix
Amendments to guidance on other IFRSs

The following amendments to guidance on other IFRSs are necessary in order to ensure consistency with IFRS 3 (as revised in 2008) and the related amendments to other IFRSs. 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.

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)
Scope exception for not-for-profit organisations	IFRSs generally do not have scope limitations for not-for-profit activities in the private or public sector. Therefore, this scope exception is not necessary for the revised IFRS 3.	SFAS 141(R) does not apply to combinations of not-for-profit organisations or the acquisition of a for-profit business by a not-for-profit organisation. The FASB is developing guidance for the accounting for mergers and acquisitions by not-for-profit organisations in a separate project. [paragraph 2(d)]
Identifying the acquirer	The guidance on control in IAS 27 *Consolidated and Separate Financial Statements* is used to identify the acquirer. The revised IFRS 3 does not have guidance for primary beneficiaries because it does not have consolidation guidance equivalent to FASB Interpretation No. 46 (revised December 2003) *Consolidation of Variable Interest Entities* (FASB Interpretation 46(R)). [Appendix A and paragraph 7]	The guidance on *controlling financial interest* in ARB No. 51 *Consolidated Financial Statements* (ARB 51), as amended, is used to identify the acquirer, unless the acquirer is the primary beneficiary of a variable interest entity. The primary beneficiary of a variable interest entity is always the acquirer and the determination of which party is the primary beneficiary is made in accordance with FASB Interpretation 46(R), not based on the guidance in ARB 51 or paragraphs A11–A15 of SFAS 141(R). [paragraphs 3(b) and 9]
Definition of control	*Control* is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [Appendix A]	*Control* has the meaning of *controlling financial interest* in paragraph 2 of ARB 51, as amended, and interpreted by FASB Interpretation 46(R). [paragraph 3(g)]
Definition of fair value	*Fair value* is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The IASB has a separate project in which it is considering the definition of fair value and related measurement guidance. [Appendix A]	*Fair value* is defined in paragraph 5 of FASB Statement No. 157 *Fair Value Measurements* 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. [paragraph 3(i)]

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 *Investment Property*. 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]

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 *contractual contingencies*, measured at their acquisition-date fair values. For all other contingencies (referred to as *non-contractual contingencies*), 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 *Elements of Financial Statements*. 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 *Accounting for Contingencies* (SFAS 5) as appropriate. [paragraphs 23–25]

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 *Provisions, Contingent Liabilities and Contingent Assets* or the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. [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 *higher* 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 *lower* of: (i) its acquisition-date fair value; or (ii) the best estimate of its future settlement amount. [paragraphs 62 and 63]

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Assets and liabilities arising from contingencies	**Disclosures** SFAS 141(R)'s disclosures related to assets and liabilities arising from contingencies are slightly different from those required by the revised IFRS 3 because the IASB's disclosures are based on the requirements in IAS 37. [the revised IFRS 3, paragraphs B64(j) and B67(c); SFAS 141(R), paragraphs 68(j) and 72(c)]	
	Application guidance SFAS 141(R) provides application guidance for applying the more-likely-than-not criterion for recognising non-contractual contingencies. The revised IFRS 3 does not have equivalent guidance. [SFAS 141(R), paragraphs A62–A65]	
Assets and liabilities for which the acquirer applies other IFRSs or US GAAP rather than the recognition and measurement principles	The revised IFRS 3 and SFAS 141(R) provide exceptions to the recognition and measurement principles for particular assets and liabilities that the acquirer accounts for in accordance with other IFRSs or US GAAP. For example, income taxes and employee benefit arrangements are accounted for in accordance with existing IFRSs or US GAAP. Differences in the existing guidance might result in differences in the amounts recognised in a business combination. For example, differences between the recognition and measurement guidance in IAS 12 *Income Taxes* and FASB Statement No. 109 *Accounting for Income Taxes* (SFAS 109) might result in differences in the amounts recognised in a business combination related to income taxes. [the revised IFRS 3, paragraphs 24–26; SFAS 141(R), paragraphs 26–28]	
Replacement share-based payment awards	The revised IFRS 3 requires an acquirer to account for share-based payment awards that it exchanges for awards held by employees of the acquiree in accordance with IFRS 2 *Share-based Payment* and SFAS 141(R) requires the acquirer to account for those awards in accordance with FASB Statement No. 123 (revised 2004) *Share-Based Payment* (SFAS 123(R)). Differences between IFRS 2 and SFAS 123(R) might cause differences in the accounting for share-based payment awards entered into as part of the business combination. In addition, the implementation guidance differs because of the different requirements in IFRS 2 and SFAS 123(R). [the revised IFRS 3, paragraphs 30 and B56–B62; SFAS 141(R), paragraphs 32, 43–46 and A91–A106]	

<table>
<tr><th>Guidance</th><th>IFRS 3 (as revised in 2008)</th><th>SFAS 141(R)</th></tr>
<tr><td rowspan="2">Contingent consideration</td><td colspan="2">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]</td></tr>
<tr><td>Subsequent measurement

Contingent consideration classified as an asset or liability that:

(a) is a financial instrument and is within the scope of IAS 39 Financial Instruments: Recognition and Measurement is measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with that IFRS.

(b) is not within the scope of IAS 39 is accounted for in accordance with IAS 37 or other IFRSs as appropriate. [paragraph 58]</td><td>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 Accounting for Derivative Instruments and Hedging Activities requires the subsequent changes to be recognised in other comprehensive income. [paragraph 65]</td></tr>
<tr><td>Subsequent measurement and accounting for assets, liabilities or equity instruments</td><td colspan="2">In general, after a business combination an acquirer measures and accounts for assets acquired, liabilities assumed or incurred and equity instruments issued in accordance with other applicable IFRSs or US GAAP, depending on their nature. Differences in the other applicable guidance might cause differences in the subsequent measurement and accounting for those assets, liabilities and equity instruments. [the revised IFRS 3, paragraphs 54 and B63; SFAS 141(R), paragraphs 60 and 66]</td></tr>
</table>

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Goodwill by reportable segment	The disclosure of goodwill by reportable segment is not required by the revised IFRS 3. Paragraph 134 of IAS 36 *Impairment of Assets* requires an entity to disclose the aggregate carrying amount of goodwill allocated to each cash-generating unit (group of units) for which the carrying amount of goodwill allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill. This information is not required to be disclosed for each material business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and occur during the period.	SFAS 141(R) requires the acquirer to disclose **for each business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and that occur during the period,** the amount of goodwill by reportable segment, if the combined entity is required to disclose segment information in accordance with FASB Statement No. 131 D*isclosures about Segments of an Enterprise and Related Information* (SFAS 131) unless such disclosure is impracticable. Like IAS 36, paragraph 45 of FASB Statement No. 142 *Goodwill and Other Intangible Assets* (SFAS 142) requires disclosure of this information in the aggregate by each reportable segment, not for each material business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and occur during the period. [paragraph 68(l)]

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Pro forma disclosures	The disclosures required by this paragraph apply to all acquirers. The revised IFRS 3 does not require the disclosure of *revenue and profit or loss* of the combined entity for the comparable prior period even if comparative financial statements are presented. [paragraph B64(q)]	The disclosures required by this paragraph apply only to acquirers that are *public business enterprises*, as described in paragraph 9 of SFAS 131. If comparative financial statements are presented, SFAS 141(R) requires disclosure of *revenue and earnings* of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (*supplemental pro forma* information). [paragraph 68(r)]
Goodwill reconciliation	The revised IFRS 3 requires an acquirer to provide a goodwill reconciliation and provides a detailed list of items that should be shown separately. [paragraph B67(d)]	SFAS 141(R) requires an acquirer to provide a goodwill reconciliation in accordance with the requirements of SFAS 142. SFAS 141(R) amends the requirement in SFAS 142 to align the level of detail in the reconciliation with that required by the IASB. As a result, there is no substantive difference between the FASB's and the IASB's requirements; however, the guidance is contained in different standards. [paragraph 72(d)]

<table>
<tr><th>Guidance</th><th>IFRS 3 (as revised in 2008)</th><th>SFAS 141(R)</th></tr>
<tr><td>Disclosures of the financial effects of adjustments to the amounts recognised in a business combination</td><td>The revised IFRS 3 requires the acquirer to disclose the amount and an explanation of any gain or loss recognised in the current period that (a) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period and (b) is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements. [paragraph B67(e)]</td><td>SFAS 141(R) does not require this disclosure.</td></tr>
<tr><td>Effective date</td><td>The revised IFRS 3 is required to 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. Early application is permitted. [paragraph 64]</td><td>SFAS 141(R) is required to 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 15 December 2008. Early application is prohibited. [paragraph 74]</td></tr>
<tr><td>Income taxes</td><td colspan="2">The revised IFRS 3 and SFAS 141(R) require the subsequent recognition of acquired deferred tax benefits in accordance with IAS 12 or SFAS 109, respectively. Differences between IAS 12 and SFAS 109 might cause differences in the subsequent recognition. Also, in accordance with US GAAP, the acquirer is required to recognise changes in the acquired income tax positions in accordance with FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes, as amended by SFAS 141(R). [the revised IFRS 3, paragraph 67; SFAS 141(R), paragraph 77]</td></tr>
</table>

The revised IFRS 3 and SFAS 141(R) have also been structured to be consistent with the style of other IFRSs and FASB standards. As a result, the paragraph numbers of the revised standards are not the same, even though the wording in the paragraphs is consistent (except for the differences identified above). This table shows how the paragraph numbers of the revised standards correspond.

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
1	1
2	2
3	4, 5
4	6
5	7
6	8
7	9
8	10
9	11
10	12
11	13
12	14
13	15
14	16
15	17
16	18
17	19
18	20
19	20
20	21
21	22
22	23
23	24, 25
24	26
25	27
26	28
27	29

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
28	30
29	31
30	32
31	33
32	34
33	35
34	36
35	37
36	38
37	39
38	40
39	41
40	42
41	47
42	48
43	49
44	50
45	51
46	52
47	53
48	54
49	55
50	56
51	57
52	58
53	59
54	60

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
55	61
56	62, 63
57	64
58	65
59	67
60	68
61	71
62	72
63	73
64	74
65	75
66	76
67	77
68	None
Appendix A	3
B1–B4	D8–D14
B5	A2
B6	A3
B7	A4
B8	A5
B9	A6
B10	A7
B11	A8
B12	A9
B13	A10
B14	A11
B15	A12

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph	IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph	IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
B16	A13	B47	A67	IE10	A125
B17	A14	B48	A68	IE11	A126
B18	A15	B49	A69	IE12	A126
B19	A108	B50	A77	IE13	A127
B20	A109	B51	A78	IE14	A128
B21	A110	B52	A79, 80	IE15	A129
B22	A111	B53	A81	IE16	A29
B23	A112	B54	A86	IE17	A30
B24	A113	B55	A87	IE18	A31
B25	A114	B56	43, 44	IE19	A32
B26	A115	B57	45, A92	IE20	A33
B27	A116	B58	A93	IE21	A34
B28	A16	B59	46, A94	IE22	A35
B29	A17	B60	A95	IE23	A36
B30	A18	B61	A96	IE24	A37
B31	A19	B62	A97–A99	IE25	A38
B32	A20	B63	66	IE26	A39
B33	A21	B64	68	IE27	A40
B34	A22	B65	69	IE28	A41
B35	A23	B66	70	IE29	A41
B36	A24	B67	72	IE30	A43
B37	A25	B68, B69	A130–A134	IE31	A42
B38	A26	IE1	A117	IE32	A44
B39	A27	IE2	A118	IE33	A45
B40	A28	IE3	A119	IE34	A46
B41	A57	IE4	A120	IE35	A47
B42	A58	IE5	A120	IE36	A48
B43	A59	IE6	A121	IE37	A49
B44	A60	IE7	A122	IE38	A50
B45	A61	IE8	A123	IE39	A51
B46	A66	IE9	A124	IE40	A52

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
IE41	A53
IE42	A54
IE43	A55
IE44	A56
IE45	A70
IE46	A71
IE47	A71
IE48	A72
IE49	None
IE50	A73
IE51	A74

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
IE52	A75
IE53	A76
IE54	A82
IE55	A83
IE56	A84
IE57	A85
IE58	A88
IE59	A89
IE60	A90
IE61	A100
IE62	A100

IFRS 3 (revised 2008) paragraph	SFAS 141(R) paragraph
IE63	A101
IE64	A102
IE65	A103
IE66	A103
IE67	A103
IE68	A104
IE69	A105
IE70	A106
IE71	A106
IE72	A107

Table of Concordance

This table shows how the contents of the superseded version of HKFRS 3 and the revised version of HKFRS 3 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded HKFRS 3 paragraph	Revised HKFRS 3 paragraph
1	1
2	2
3	2
4	2, 3
5	B5, B6
6	B6
7	B6
8	43
9	None
10	B1
11	B2
12	B3
13	B4
14	4
15	None
16	5
17	6, 7
18	None
19	7
20	B13–B16
21	B15
22	B18
23	B17
24	37, 38

Superseded HKFRS 3 paragraph	Revised HKFRS 3 paragraph
25	8, 41, 42
26	None
27	None
28	11
29–31	53
32–35	39, 40, 58
36	10, 18, 31
37	10
38	HKAS 27.26 (Revised)
39	8, 9
40	19
41	11
42	None
43	11
44	13
45, 46	B31–B34
47–50	22, 23, 56, B64(j), B67(c)
51	32
52	Appendix A
53	35
54, 55	B63(a)
56, 57	34–36
58–60	41, 42
61–64	45–50

Superseded HKFRS 3 paragraph	Revised HKFRS 3 paragraph
65	HKAS 12.68
66	59
67	60, B64
68	B65
69	B67(a)
70	B64(q)
71	B66
72	61
73	62, B67
74–76	B67(d)
77	63
78–85	64–67, B68, B69
86, 87	68
Appendix A	Appendix A, B7, B12
B1–B3	B19
B4–B6	B20
B7–B9	B21, B22
B10, B11	B23, B24
B12–B15	B25–B27
B16	None
B17	None
None	12, 14–17, 20, 21, 24–30, 33, 44, 51, 52, 54, 55, 57
None	B8–B11, B28–B30, B35–B62

The main revisions made in 2008 were:

- The scope was broadened to cover business combinations involving only mutual entities and business combinations achieved by contract alone.
- The definitions of a *business* and a *business combination* were amended and additional guidance was added for identifying when a group of assets constitutes a business.
- For each business combination, the acquirer must measure any non-controlling interest in the acquiree either at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets. Previously, only the latter was permitted.
- The requirements for how the acquirer makes any classifications, designations or assessments for the identifiable assets acquired and liabilities assumed in a business combination were clarified.
- The period during which changes to deferred tax benefits acquired in a business combination can be adjusted against goodwill has been limited to the measurement period (through a consequential amendment to HKAS 12 *Income Taxes*).
- An acquirer is no longer permitted to recognise contingencies acquired in a business combination that do not meet the definition of a liability.
- Costs the acquirer incurs in connection with the business combination must be accounted for separately from the business combination, which usually means that they are recognised as expenses (rather than included in goodwill).
- Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with HKAS 39, HKAS 37 or other HKFRSs, as appropriate (rather than by adjusting goodwill). The disclosures required to be made in relation to contingent consideration were enhanced.
- Application guidance was added in relation to when the acquirer is obliged to replace the acquiree's share-based payment awards; measuring indemnification assets; rights sold previously that are reacquired in a business combination; operating leases; and valuation allowances related to financial assets such as receivables and loans.
- For business combinations achieved in stages, having the acquisition date as the single measurement date was extended to include the measurement of goodwill. An acquirer must remeasure any equity interest it holds in the acquiree immediately before achieving control at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss.

HKFRS 3 Business Combinations

Illustrative Examples

©Copyright

Contents

IFRS 3 Business Combinations

Illustrative Examples

Examples of items acquired in a business combination that meet the definition of an intangible asset

Customer relationship intangible assets acquired in a business combination

Reverse acquisitions

Business combination achieved in stages

Changes in the values assigned to the acquiree's identifiable assets

IFRS 3 Business Combinations

Illustrative Examples

These examples accompany, but are not part of, IFRS 3.

Examples of items acquired in a business combination that meet the definition of an intangible asset

The following guidance provides examples of items acquired in a business combination that meet the definition of an intangible asset and are therefore recognised under IFRS 3 *Business Combinations* separately from goodwill, provided that their fair values can be measured reliably. To meet the definition of an intangible asset a non-monetary asset without physical substance must be identifiable, ie it must arise from contractual or other legal rights or be separable.

The examples provided below are not intended to be an exhaustive list of items acquired in a business combination that meet the definition of an intangible asset. A non-monetary asset without physical substance acquired in a business combination might meet the identifiability criterion for identification as an intangible asset but not be included in this guidance.

Assets designated with the symbol # are those that meet the definition of an intangible asset because they arise from contractual or other legal rights. Assets designated with the symbol * do not arise from contractual or other legal rights, but meet the definition of an intangible asset because they are separable. Assets designated with the symbol # might also be separable; however, separability is not a necessary condition for an asset to meet the contractual-legal criterion.

A Marketing-related intangible assets

1 Trademarks, trade names, service marks, collective marks and certification marks #

Trademarks are words, names, symbols or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks are used to identify the goods or services of members of a group. Certification marks are used to certify the geographical origin or other characteristics of a good or service.

Trademarks, trade names, service marks, collective marks and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce, or by other means. Provided it is protected legally through registration or other means, a trademark or other mark acquired in a business combination is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired in a business combination can meet the definition of an intangible asset provided the separability criterion is met, which would normally be the case.

The terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.

2 Internet domain names #

An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination is an intangible asset that meets the contractual-legal criterion.

3 Trade dress (unique colour, shape or package design) #

4 Newspaper mastheads #

5 Non-competition agreements #

B Customer-related intangible assets

1 Customer lists *

A customer list consists of information about customers, such as their name and contact information. A customer list may also be in the form of a database that includes other information about the customers such as their order history and demographic information. A customer list does not generally arise from contractual or other legal rights. However, customer lists are valuable and are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion for identification as an intangible asset. However, a customer list acquired in a business combination would not meet that criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

2 Order or production backlog #

An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion for identification as an intangible asset, even if the purchase or sales orders are cancellable.

3 Customer contracts and the related customer relationships #

If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion for identification as intangible assets. This will be the case even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquired entity or business.

Customer relationships also meet the contractual-legal criterion for identification as intangible assets when an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the date of acquisition.

As noted in B2, an order or a production backlog arises from contracts such as purchase or sales orders, and is therefore also considered a contractual right. Consequently, if an entity has customer relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights, and therefore meet the contractual-legal criterion for identification as intangible assets.

©Copyright

4 Non-contractual customer relationships *

If a customer relationship acquired in a business combination does not arise from a contract, the relationship is an intangible asset if it meets the separability criterion. Exchange transactions for the same asset or a similar asset provide evidence of separability of a non-contractual customer relationship and might also provide information about exchange prices that should be considered when estimating fair value.

C Artistic-related intangible assets

Artistic-related assets acquired in a business combination meet the criteria for identification as intangible assets if they arise from contractual or legal rights such as those provided by copyright. Copyrights can be transferred either in whole through assignments or in part through licensing agreements. An entity is not precluded from recognising a copyright intangible asset and any related assignments or licence agreements as a single asset, provided they have similar useful lives.

1 Plays, operas and ballets #

2 Books, magazines, newspapers and other literary works #

3 Musical works such as compositions, song lyrics and advertising jingles #

4 Pictures and photographs #

5 Video and audiovisual material, including films, music videos and television programmes #

D Contract-based intangible assets

1 Licensing, royalty and standstill agreements #

2 Advertising, construction, management, service or supply contracts #

3 Lease agreements #

4 Construction permits #

5 Franchise agreements #

6 Operating and broadcasting rights #

7 Use rights such as drilling, water, air, mineral, timber-cutting and route authorities #

8 Servicing contracts such as mortgage servicing contracts #

Contracts to service financial assets are one particular type of contract-based intangible asset. While servicing is inherent in all financial assets, it becomes a distinct asset (or liability):

(a) when contractually separated from the underlying financial asset by sale or securitisation of the assets with servicing retained; or

(b) through the separate purchase and assumption of the servicing.

If mortgage loans, credit card receivables or other financial assets are acquired in a business combination with servicing retained, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.

9 Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is below their current market value #

E Technology-based intangible assets

1 Patented technology #

2 Computer software and mask works #

If computer software and program formats acquired in a business combination are protected legally, such as by patent or copyright, they meet the contractual-legal criterion for identification as intangible assets. Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry.

Mask works may have legal protection. Mask works with legal protection that are acquired in a business combination also meet the contractual-legal criterion for identification as intangible assets.

3 Unpatented technology *

4 Databases *

Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. If a database acquired in a business combination is protected by copyright, it meets the contractual-legal criterion for identification as an intangible asset. However, a database typically includes information created as a consequence of an entity's normal operations, such as customer lists, or specialised information such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in a business combination meets the separability criterion for identification as an intangible asset.

5 Trade secrets such as secret formulas, processes or recipes #

If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion for identification as an intangible asset. Otherwise, trade secrets acquired in a business combination meet the definition of an intangible asset only if the separability criterion is met, which is often likely to be the case.

Customer relationship intangible assets acquired in a business combination

The following examples illustrate the recognition in accordance with IFRS 3 *Business Combinations* of customer relationship intangible assets acquired in a business combination.

©Copyright

Example 1

Background

Parent obtained control of Supplier in a business combination on 31 December 20X4. Supplier has a five-year agreement to supply goods to Buyer. Both Supplier and Parent believe that Buyer will renew the supply agreement at the end of the current contract. The supply agreement is not separable.

Analysis

The supply agreement (whether cancellable or not) meets the contractual-legal criterion for identification as an intangible asset, and therefore is recognised separately from goodwill, provided its fair value can be measured reliably. Additionally, because Supplier establishes its relationship with Buyer through a contract, the customer relationship with Buyer meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill provided its fair value can be measured reliably. In determining the fair value of the customer relationship, Parent considers assumptions such as the expected renewal of the supply agreement.

Example 2

Background

Parent obtained control of Subsidiary in a business combination on 31 December 20X4. Subsidiary manufactures goods in two distinct lines of business—sporting goods and electronics. Customer purchases from Subsidiary both sporting goods and electronics. Subsidiary has a contract with Customer to be its exclusive provider of sporting goods. However, there is no contract for the supply of electronics to Customer. Both Subsidiary and Parent believe that there is only one overall customer relationship between Subsidiary and Customer.

Analysis

The contract to be Customer's exclusive supplier of sporting goods (whether cancellable or not) meets the contractual-legal criterion for identification as an intangible asset, and is therefore recognised separately from goodwill, provided its fair value can be measured reliably. Additionally, because Subsidiary establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill, provided its fair value can be measured reliably. Because there is only one customer relationship with Customer, the fair value of that relationship incorporates assumptions regarding Subsidiary's relationship with Customer related to both sporting goods and electronics.

However, if both Parent and Subsidiary believed there were separate customer relationships with Customer—one for sporting goods and another for electronics—the customer relationship with respect to electronics would be assessed by Parent to determine whether it meets the separability criterion for identification as an intangible asset.

©Copyright

Example 3

Background

Entity A obtained control of Entity B in a business combination on 31 December 20X4. Entity B does business with its customers solely through purchase and sales orders. At 31 December 20X4, Entity B has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of Entity B's customers are also recurring customers. However, as of 31 December 20X4, Entity B does not have any open purchase orders or other contracts with those customers.

Analysis

The purchase orders from 60 per cent of Entity B's customers (whether cancellable or not) meet the contractual-legal criterion for identification as intangible assets, and are therefore recognised separately from goodwill, provided their fair values can be measured reliably. Additionally, because Entity B has established its relationship with 60 per cent of its customers through contracts, those customer relationships meet the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill provided its fair value can be measured reliably.

Because Entity B has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights, and therefore meets the contractual-legal criterion for identification as an intangible asset. Entity A recognises this customer relationship separately from goodwill, provided its fair value can be measured reliably, even though Entity B does not have contracts with those customers at 31 December 20X4.

Example 4

Background

Parent obtained control of Insurer in a business combination on 31 December 20X4. Insurer has a portfolio of one-year motor insurance contracts that are cancellable by policyholders. A reasonably predictable number of policyholders renew their insurance contracts each year.

Analysis

Because Insurer establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is recognised separately from goodwill, provided its fair value can be measured reliably. In determining the fair value of the customer relationship intangible asset, Parent considers estimates of renewals and cross-selling. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

In determining the fair value of the liability relating to the portfolio of insurance contracts, Parent considers estimates of cancellations by policyholders. IFRS 4 *Insurance Contracts* permits, but does not require, 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

©Copyright

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset is excluded from the scope of IAS 36 and IAS 38. After the business combination, Parent is required to measure that intangible asset on a basis consistent with the measurement of the related insurance liability.

Reverse acquisitions

The following example illustrates the application of the guidance on reverse acquisition accounting provided as an application supplement in paragraphs B1-B15 of Appendix B of IFRS 3 *Business Combinations*.

Example 5

This example illustrates the accounting for a reverse acquisition in which Entity A, the entity issuing equity instruments and therefore the legal parent, is acquired in a reverse acquisition by Entity B, the legal subsidiary, on 30 September 20X1. The accounting for any income tax effects is ignored in this example:

Balance sheets of A and B immediately before the business Combination

	A	B
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
	700	1,700
Owners' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
	1,100	2,000
	1,800	3,700

Other information

(a) On 30 September 20X1, A issues 2½ shares in exchange for each ordinary share of B. All of B's shareholders exchange their shares in B. Therefore, A issues 150 ordinary shares in exchange for all 60 ordinary shares of B.

(b) The fair value of each ordinary share of B at 30 September 20X1 is CU40. The quoted market price of A's ordinary shares at that date is CU12.

(c) The fair values of A's identifiable assets and liabilities at 30 September 20X1 are the same as their carrying amounts, with the exception of non-current assets. The fair value of A's non-current assets at 30 September 20X1 is CU1,500.

Calculating the cost of the business combination

As a result of the issue of 150 ordinary shares by A, B's shareholders own 60 per cent of the issued shares of the combined entity (ie 150 shares out of 250 issued shares). The remaining 40 per cent are owned by A's shareholders. If the business combination had taken place in the form of B issuing additional ordinary shares to A's shareholders in exchange for their ordinary shares in A, B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. B's shareholders would then own 60 out of the 100 issued shares of B and therefore 60 per cent of the combined entity.

As a result, the cost of the business combination is CU1,600 (ie 40 shares each with a fair value of CU40).

Measuring goodwill

Goodwill is measured as the excess of the cost of the business combination over the net fair value of A's identifiable assets and liabilities. Therefore, goodwill is measured as follows:

	CU	CU
Cost of the business combination		1,600
Net fair value of A's identifiable assets and liabilities:		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	1,300
Goodwill		300

©Copyright

Consolidated balance sheet at 30 September 20X1

			CU
Current assets [CU700 + CU500]			1,200
Non-current assets [CU3,000 + CU1,500]			4,500
Goodwill			300
			6,000
Current liabilities [CU600 + CU300]			900
Non-current liabilities [CU1,100 + CU400]			1,500
			2,400
Owners' equity			
	Retained earnings		1,400
	Issued equity		
		250 ordinary shares [CU600 + CU1,600]*	2,200
			3,600
			6,000

Earnings per share

Assume that B's profit for the annual period ending 31 December 20X0 was CU600, and that the consolidated profit for the annual period ending 31 December 20X1 is CU800. Assume also that there was no change in the number of ordinary shares issued by B during the annual period ending 31 December 20X0 and during the period from 1 January 20X1 to the date of the reverse acquisition (30 September 20X1).

Earnings per share for the annual period ending 31 December 20X1 is calculated as follows:

Restated earnings per share for the annual period ending 31 December 20X0 is 4.00 (ie the profit of B of 600 divided by the number of ordinary shares issued by A in the reverse acquisition).

Minority interest

In the above example, assume that only 56 of B's ordinary shares are tendered for exchange rather than all 60. Because A issues 2½ shares in exchange for each ordinary share of B, A issues only 140 (rather than 150) shares. As a result, B's shareholders own 58.3 per cent of the issued shares of the combined entity (ie 140 shares out of 240 issued shares).

* In accordance with paragraph B7(c) of IFRS 3, the amount recognised as issued equity instruments in the consolidated financial statements is determined by adding to the issued equity of the legal subsidiary immediately before the business combination [CU600] the cost of the combination [CU1,600]. However, the equity structure appearing in the consolidated financial statements (ie the number and type of equity instruments issued) must reflect the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the combination.

©Copyright

The cost of the business combination is calculated by assuming that the combination had taken place in the form of B issuing additional ordinary shares to the shareholders of A in exchange for their ordinary shares in A. In calculating the number of shares that would have to be issued by B, the minority interest is ignored. The majority shareholders own 56 shares of B. For this to represent a 58.3 per cent ownership interest, B would have had to issue an additional 40 shares. The majority shareholders would then own 56 out of the 96 issued shares of B and therefore 58.3 per cent of the combined entity.

As a result, the cost of the business combination is CU1,600 (ie 40 shares each with a fair value of CU40). This is the same amount as when all 60 of B's ordinary shares are tendered for exchange. The cost of the combination does not change simply because some of B's shareholders do not participate in the exchange.

The minority interest is represented by the 4 shares of the total 60 shares of B that are not exchanged for shares of A. Therefore, the minority interest is 6.7 per cent. The minority interest reflects the minority shareholders' proportionate interest in the pre-combination carrying amounts of the net assets of the legal subsidiary. Therefore, the consolidated balance sheet is adjusted to show a minority interest of 6.7 per cent of the pre-combination carrying amounts of B's net assets (ie CU134 or 6.7 per cent of CU2,000).

The consolidated balance sheet at 30 September 20X1 reflecting the minority interest is as follows:

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
	2,400
Owners' equity	
Retained earnings [CU1,400 × 93.3%]	1,306
Issued equity	2,160
240 ordinary shares [CU560 + CU1,600]	
Minority interest	134
	3,600
	6,000

Business combination achieved in stages

The following example illustrates the application of the guidance on business combinations achieved in stages in paragraphs 58-60 of IFRS 3 *Business Combinations*. In particular, it deals with successive share purchases that result in an investee previously accounted for at

©Copyright

fair value being included as a subsidiary in the consolidated financial statements.

Immediately following the example is a discussion of the outcome of applying the guidance in paragraphs 58-60 of IFRS 3 to the example assuming the investee had previously been accounted for at cost or by applying the equity method, rather than at fair value.

Example 6

Investor acquires a 20 per cent ownership interest in Investee (a service company) on 1 January 20X1 for CU3,500,000 cash. At that date, the fair value of Investee's identifiable assets is CU10,000,000, and the carrying amount of those assets is CU8,000,000. Investee has no liabilities or contingent liabilities at that date. The following shows Investee's balance sheet at 1 January 20X1 together with the fair values of the identifiable assets:

	Carrying amounts	Fair values
	CU	CU
Cash and receivables	2,000,000	2,000,000
Land	6,000,000	8,000,000
	8,000,000	10,000,000
Issued equity: 1,000,000 ordinary shares	5,000,000	
Retained earnings	3,000,000	
	8,000,000	

During the year ended 31 December 20X1, Investee reports a profit of CU6,000,000 but does not pay any dividends. In addition, the fair value of Investee's land increases by CU3,000,000 to CU11,000,000. However, the amount recognised by Investee in respect of the land remains unchanged at CU6,000,000. The following shows Investee's balance sheet at 31 December 20X1 together with the fair values of the identifiable assets:

	Carrying amounts	Fair values
	CU	CU
Cash and receivables	8,000,000	8,000,000
Land	6,000,000	11,000,000
	14,000,000	19,000,000
Issued equity: 1,000,000 ordinary shares	5,000,000	
Retained earnings	9,000,000	
	14,000,000	

On 1 January 20X2, Investor acquires a further 60 per cent ownership interest in Investee for CU22,000,000 cash, thereby obtaining control. Before obtaining control, Investor does *not* have significant influence over Investee, and accounts for its initial 20 per cent investment at fair value with changes in value included in profit or loss. Investee's ordinary shares have a

quoted market price at 31 December 20X1 of CU30 per share.*

Throughout the period 1 January 20X1 to 1 January 20X2, Investor's issued equity was CU30,000,000. Investor's only asset apart from its investment in Investee is cash.

Accounting for the initial investment before obtaining control

Investor's initial 20 per cent investment in Investee is measured at CU3,500,000. However, Investee's 1,000,000 ordinary shares have a quoted market price at 31 December 20X1 of CU30 per share. Therefore, the carrying amount of Investor's initial 20 per cent investment is remeasured in Investor's financial statements to CU6,000,000 at 31 December 20X1, with the CU2,500,000 increase recognised in profit or loss for the period. Therefore, Investor's balance sheet at 31 December 20X1, before the acquisition of the additional 60 per cent ownership interest, is as follows:

	CU
Cash	26,500,000
Investment in Investee	6,000,000
	32,500,000
Issued equity	30,000,000
Retained earnings	2,500,000
	32,500,000

Accounting for the business combination

Paragraph 25 of IFRS 3 states that when a business combination involves more than one exchange transaction, the cost of the combination is the aggregate cost of the individual transactions, with the cost of each individual transaction determined at the date of each exchange transaction (ie the date that each individual investment is recognised in the acquirer's financial statements). This means that for this example, the cost to Investor of the business combination is the aggregate of the cost of the initial 20 per cent ownership interest (CU3,500,000) plus the cost of the subsequent 60 per cent ownership interest (CU22,000,000), irrespective of the fact that the carrying amount of the initial 20 per cent interest has changed.

In addition, and in accordance with paragraph 58 of IFRS 3, each transaction must be treated separately to determine the goodwill on that transaction, using cost and fair value information at the date of each exchange transaction. Therefore, Investor recognises the following amounts for goodwill in its consolidated financial statements:

For the 20% ownership interest costing CU3,500,000:

goodwill = 3,500,000 – [20% × 10,000,000] = CU1,500,000

For the 60% ownership interest costing CU22,000,000:

goodwill = 22,000,000 – [60% × 19,000,000] = CU10,600,000

* Therefore, Investee's market capitalisation at 31 December 20X1 is CU30,000,000. However, Investor paid CU22,000,000 for the additional 60 per cent of the issued shares and control of Investee on 1 January 20X2. This indicates that Investor paid a significant premium for control of Investee.

©Copyright

The following shows Investor's consolidation worksheet (all amounts in CU) immediately after the acquisition of the additional 60 per cent ownership interest in Investee, together with consolidation adjustments and associated explanations:

	Investor	Investee	Consolidation Adjustments Dr	Consolidation Adjustments Cr	Consolidated	
Net Assets						
Cash and receivables	4,500	8,000		2,500 (2)	12,500	
Investment in Investee	28,000	-		3,500 (3)	-	
				22,000 (4)		
Land	-	6,000	5,000 (1)		11,000	See note (a)
Goodwill	-	-	1,500 (3)		12,100	See note (b)
			10,600 (4)			
	32,500	14,000			35,600	
Issued equity	30,000	5,000	1,000 (3)		30,000	See note (c)
			3,000 (4)			
			1,000 (5)			
Asset revaluation surplus	-	-	400 (3)	5,000 (1)	600	See note (d)
			3,000 (4)			
			1,000 (5)			
Retained earnings	2,500	9,000	2,500 (2)		1,200	See note (e)
			600 (3)			
			5,400 (4)			
			1,800 (5)			
Minority interest	-	-		3,800 (5)	3,800	See note (a)
	32,500	14,000			35,600	

Consolidation Adjustments

		Dr	Cr
(1)	Land	5,000	
	Asset revaluation surplus		5,000
	To recognise Investee's identifiable assets at fair values at the acquisition date		
(2)	Retained earnings	2,500	
	Investment in Investee		2,500
	To restate the initial 20 per cent investment in Investee to cost		
(3)	Issued equity [20% × 5,000]	1,000	
	Asset revaluation surplus [20% × 2,000*]	400	
	Retained earnings [20% × 3,000]	600	
	Goodwill	1,500	
	Investment in Investee		3,500
	To recognise goodwill on the initial 20 per cent investment in Investee and record the elimination of that investment against associated equity balances		
(4)	Issued equity [60% × 5,000]	3,000	
	Asset revaluation surplus [60% × 5,000]	3,000	
	Retained earnings [60% × 9,000]	5,400	
	Goodwill	10,600	
	Investment in Investee		22,000
	To recognise goodwill on the subsequent 60 per cent investment in Investee and record elimination of that investment against associated equity balances		
(5)	Issued equity [20% × 5,000]	1,000	
	Asset revaluation surplus [20% × 5,000]	1,000	
	Retained earnings [20% × 9,000]	1,800	
	Minority interest (in issued equity)		1,000
	Minority interest (in asset revaluation surplus)		1,000
	Minority interest (in retained earnings)		1,800
	To recognise the minority interest in the Investee		

* The CU2,000,000 asset revaluation surplus represents the amount by which the fair value of Investee's land at the date of the first exchange transaction exceeds its carrying amount; the carrying amount of the land at the date Investor acquired the initial 20 per cent interest was CU6,000,000, but its fair value was CU8,000,000. In accordance with paragraph 58 of IFRS 3, each transaction must be treated separately for the purpose of determining the amount of goodwill on that transaction, using cost and fair value information at the date of each exchange transaction.

Notes

The above consolidation adjustments result in:

(a) Investee's identifiable net assets being stated at their full fair values at the date Investor obtains control of Investee. This means that the 20 per cent minority interest in Investee also is stated at the minority's 20 per cent share of the fair values of Investee's identifiable net assets.

(b) goodwill being recognised from the acquisition date at an amount based on treating each exchange transaction separately and using cost and fair value information at the date of each exchange transaction.

(c) issued equity of CU30,000,000 comprising the issued equity of Investor of CU30,000,000.

(d) an asset revaluation surplus of CU600,000. This amount reflects that part of the increase in the fair value of Investee's identifiable net assets after the acquisition of the initial 20 per cent interest that is attributable to that initial 20 per cent interest [20% × CU3,000,000].

(e) a retained earnings balance of CU1,200,000. This amount reflects the changes in Investee's retained earnings after Investor acquired its initial 20 per cent interest that is attributable to that 20 per cent interest [20% × CU6,000,000].

Therefore, the effect of applying the requirements in IFRS 3 to business combinations involving successive share purchases for which the investment was previously accounted for at fair value with changes in value included in profit or loss is to cause:

- changes in the fair value of previously held ownership interests to be reversed (so that the carrying amounts of those ownership interests are restated to cost).
- changes in the investee's retained earnings and other equity balances after each exchange transaction to be included in the post-combination consolidated financial statements to the extent that they relate to the previously held ownership interests.

Applying IFRS 3 if the investee had previously been accounted for at cost or using the equity method

As discussed above, paragraph 25 of IFRS 3 requires the cost of a business combination involving more than one exchange transaction to be measured as the aggregate cost of the individual transactions, with the cost of each individual transaction determined at the date of each exchange transaction (ie the date that each individual investment is recognised in the acquirer's financial statements). Therefore, irrespective of whether the initial 20 per cent investment in Investee is accounted for at cost, by applying the equity method or at fair value, the cost to Investor of the combination is the aggregate of the cost of the initial 20 per cent ownership interest (CU3,500,000) plus the cost of the subsequent 60 per cent ownership interest (CU22,000,000).

In addition, and again irrespective of whether the initial 20 per cent investment in Investee is accounted for at cost, by applying the equity method or at fair value, each transaction must be treated separately for the purpose of determining the amount of goodwill on that transaction, using cost and fair value information at the date of each exchange transaction.

Therefore, the effect of applying IFRS 3 to any business combination involving successive share purchases is to cause:

- any changes in the carrying amount of previously held ownership interests to be reversed (so that the carrying amounts of those ownership interests are restated to cost).
- changes in the investee's retained earnings and other equity balances after each exchange transaction to be included in the post-combination consolidated financial statements to the extent that they relate to the previously held ownership interests.

Consequently, the consolidated financial statements immediately after Investor acquires the additional 60 per cent ownership interest and obtains control of Investee would be the same irrespective of the method used to account for the initial 20 per cent investment in Investee before obtaining control.

Changes in the values assigned to the acquiree's identifiable assets

Completing the initial accounting for a business combination

The following example illustrates the application of the guidance in paragraph 62 of IFRS 3 *Business Combinations* on completing the initial accounting for a business combination when the acquirer has, at the end of the first period after the combination, accounted for the combination using provisional values. This example does not address the accounting for any income tax effects arising from the adjustments.

IFRS 3 requires the acquirer to account for a business combination using provisional values if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination is effected. The acquirer is required to recognise any adjustments to those provisional values as a result of completing the initial accounting:

(a) within twelve months of the acquisition date; and

(b) from the acquisition date. Therefore:

    (i) the carrying amount of an identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing the initial accounting is calculated as if its fair value at the acquisition date had been recognised from that date.

    (ii) goodwill or any gain recognised in accordance with paragraph 56 is adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.

    (iii) comparative information presented for the periods before the initial accounting for the combination is complete is presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortisation or other profit or loss effects recognised as a result of completing the initial accounting.

Example 7

An entity prepares financial statements for annual periods ending on 31 December and does not prepare interim financial statements. The entity was the acquirer in a business combination on 30 September 20X4. The entity sought an independent appraisal for an item of property, plant and equipment acquired in the combination. However, the appraisal was not finalised by the time the entity completed its 20X4 annual financial statements. The entity recognised in its 20X4 annual financial statements a provisional fair value for the asset of CU30,000, and a provisional value for acquired goodwill of CU100,000. The item of property, plant and equipment had a remaining useful life at the acquisition date of five years.

Four months after the acquisition date, the entity received the independent appraisal, which estimated the asset's fair value at the acquisition date at CU40,000.

As outlined in paragraph 62 of IFRS 3, the acquirer is required to recognise any adjustments to provisional values as a result of completing the initial accounting from the acquisition date.

Therefore, in the 20X5 financial statements, an adjustment is made to the opening carrying amount of the item of property, plant and equipment. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000, less the additional depreciation that would have been recognised had the asset's fair value at the acquisition date been recognised from that date (CU500 for three months' depreciation to 31 December 20X4). The carrying amount of goodwill is also adjusted for the reduction in value at the acquisition date of CU10,000, and the 20X4 comparative information is restated to reflect this adjustment and to include additional depreciation of CU500 relating to the year ended 31 December 20X4.

In accordance with paragraph 69 of IFRS 3, the entity discloses in its 20X4 financial statements that the initial accounting for the business combination has been determined only provisionally, and explains why this is the case. In accordance with paragraph 73(b) of IFRS 3, the entity discloses in its 20X5 financial statements the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period. Therefore, the entity discloses that:

- the fair value of the item of property, plant and equipment at the acquisition date has been increased by CU10,000 with a corresponding decrease in goodwill; and

- the 20X4 comparative information is restated to reflect this adjustment and to include additional depreciation of CU500 relating to the year ended 31 December 20X4.

Error corrections

The following examples illustrate the application of the guidance in paragraphs 63 and 64 of IFRS 3 on the accounting for error corrections related to the initial accounting for a business combination. These examples do not address the accounting for any income tax effects arising from the adjustments.

With three exceptions,[*] IFRS 3 requires adjustments to be made to the initial accounting for a business combination after that initial accounting is complete only to correct an error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

[*] Two of the three exceptions relate to adjustments to the cost of a business combination after the initial accounting for the combination is complete. The third relates to the subsequent recognition by the acquirer of the acquiree's deferred tax assets that did not satisfy the criteria for separate recognition when initially accounting for the business combination.

After that accounting is completed, adjustments cannot be recognised for the effect of changes in accounting estimates. In accordance with IAS 8, the effect of a change in an accounting estimate is recognised prospectively. IAS 8 provides guidance on distinguishing corrections of errors from changes in accounting estimates.

Example 8

An entity prepares financial statements for annual periods ending on 31 December and does not prepare interim financial statements. The entity was the acquirer in a business combination on 30 September 20X1. As part of the initial accounting for that combination, the entity recognised goodwill of CU100,000. The carrying amount of goodwill at 31 December 20X1 was CU100,000. During 20X2, the entity becomes aware of an error relating to the amount initially allocated to property, plant and equipment assets acquired in the business combination. In particular, CU20,000 of the CU100,000 initially allocated to goodwill should be allocated to property, plant and equipment assets that had a remaining useful life at the acquisition date of five years.

As outlined in paragraph 64 of IFRS 3, IAS 8 requires the correction of an error to be accounted for retrospectively, and for the financial statements to be presented as if the error had never occurred by correcting the error in the comparative information for the prior period(s) in which it occurred.

Therefore, in the 20X2 financial statements, an adjustment is made to the opening carrying amount of property, plant and equipment assets.That adjustment is measured as the fair value adjustment at the acquisition date of CU20,000 less the amount that would have been recognised as depreciation of the fair value adjustment (CU1,000 for three months' depreciation to 31 December 20X1). The carrying amount of goodwill is also adjusted for the reduction in value at the acquisition date of CU20,000, and the 20X1 comparative information is restated to reflect this adjustment and to include additional depreciation of CU1,000 relating to the year ended 31 December 20X1.

In accordance with IAS 8, the entity discloses in its 20X2 financial statements the nature of the error and that, as a result of correcting that error, an adjustment was made to the carrying amount of property, plant and equipment. The entity also discloses that:

- the fair value of property, plant and equipment assets at the acquisition date has been increased by CU20,000 with a corresponding decrease in goodwill; and]

- the 20X1 comparative information is restated to reflect this adjustment and to include additional depreciation of CU1,000 relating to the year ended 31 December 20X1.

Example 9

This example assumes the same facts as in Example 8, except that the amount initially allocated to property, plant and equipment assets is decreased by CU20,000 to correct the error, rather than increased by CU20,000. This example also assumes that the entity determines that the recoverable amount of the additional goodwill is only CU17,000 at 31 December 20X1.

In the 20X2 financial statements, the opening carrying amount of property, plant and equipment assets is reduced by CU19,000, being the fair value adjustment at the acquisition date of CU20,000 less CU1,000 in depreciation expense recognised for the three-month period to 31 December 20X1. The carrying amount of goodwill is increased by CU17,000, being the increase in value at the acquisition date of CU20,000 less a CU3,000 impairment

©Copyright

loss to reflect that the carrying amount of the adjustment exceeds its recoverable amount. The 20X1 comparative information is restated to reflect this adjustment and to exclude the CU1,000 depreciation and include the CU3,000 impairment loss.

In accordance with IAS 8, the entity discloses in its 20X2 financial statements the nature of the error and that, as a result of correcting that error, an adjustment was made to the carrying amount of property, plant and equipment. The entity also discloses that:

- the fair value of property, plant and equipment assets at the acquisition date has been decreased by CU20,000 with a corresponding increase in goodwill; and
- the 20X1 comparative information is restated to reflect this adjustment and to exclude CU1,000 depreciation recognised during the year ended 31 December 20X1 and include a CU3,000 impairment loss for goodwill relating to the year ended 31 December 20X1.

HKFRS 4

~~Issued August 2004~~Revised February 2010

Hong Kong Financial Reporting Standard 4

Insurance Contracts

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by International Accounting Standards Committee Foundation. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

Contents

Paragraphs

INTRODUCTION **IN1-IN11**

HONG KONG FINANCIAL REPORTING STANDARD 4
INSURANCE CONTRACTS

OBJECTIVE **1**
SCOPE **2-12**
Embedded derivatives **7-9**
Unbundling of deposit components **10-12**
RECOGNITION AND MEASUREMENT **13-35**
Temporary exemption from some other HKFRSs **13-20**
Liability adequacy test 15-19
Impairment of reinsurance assets 20
Changes in accounting policies **21-30**
Current market interest rates 24
Continuation of existing practices 25
Prudence 26
Future investment margins 27-29
Shadow accounting 30
Insurance contracts acquired in a business combination or portfolio transfer **31-33**
Discretionary participation features **34-35**
Discretionary participation features in insurance contracts 34
Discretionary participation features in financial instruments 35
DISCLOSURE **36-39**
Explanation of recognised amounts **36-37**
Nature and extent of risks arising from insurance contracts **38-39A**
EFFECTIVE DATE AND TRANSITION **40-45**
Disclosure **42-44**
Redesignation of financial assets **45**
APPENDICES

© Copyright

A Defined terms

B Definition of an insurance contract

C Amendments to other HKFRSs

D Comparison with International Financial Reporting Standards

E Amendments resulting from other HKFRSs

BASIS FOR CONCLUSIONS

IMPLEMENTATION GUIDANCE

Hong Kong Financial Reporting Standard 4 *Insurance Contracts* (HKFRS 4) is set out in paragraphs 1-45 and Appendices A-C and E. 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 *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.

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 ~~Society of~~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 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 ~~reporting date~~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 ~~balance sheet~~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 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 ~~balance sheet~~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 from insurance contracts.

IN12 ~~Entities should apply the HKFRS for annual periods beginning on or after 1 January 2005, but earlier application is encouraged. An insurer need not apply some aspects of the HKFRS to comparative information that relates to annual periods beginning before 1 January 2005.~~[Deleted]

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), except in the transitional provisions in paragraph 45.

4. An entity shall not apply this HKFRS to:

(a) product warranties issued directly by a manufacturer, dealer or retailer (see 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*, HKAS 18 *Revenue* and HKAS 38 *Intangible Assets*).

© Copyright

(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 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.

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 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. 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 requirement in 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 requirement in HKAS 39 does 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, that requirement also applies 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.

© Copyright

(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 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 ~~reporting date~~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 ~~balance sheet~~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~~date~~ 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:

(e) 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).

(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.

* 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.

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.

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).

© Copyright

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 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

---

[*] In this paragraph, insurance liabilities include related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32.

(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 ~~equity~~ other comprehensive income if, and only if, the unrealised gains or losses are recognised ~~directly in equity~~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

© Copyright

of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to ~~minority interests~~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 HKAS 39, apply 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 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 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 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.

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 ~~cash flow statement~~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.

(e) 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 ~~analysis~~ 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 ~~balance sheet~~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 ~~had~~ if changes in the relevant risk variable that were reasonably possible at the ~~balance sheet date~~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.

Effective date and transition

40 The transitional provisions in paragraphs 41-45 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.

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.

* When an entity applies HKFRS 7, the reference to HKAS 32 is replaced by reference to HKFRS 7

Redesignation of financial assets

45 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 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.

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 HKAS 39 and would be within the scope of 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 — The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

financial guarantee contract — A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

financial risk — The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

guaranteed benefits — Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

© Copyright

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.

© Copyright

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 HKAS 18 *Revenue* applied, the service provider would recognise revenue 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.

© Copyright

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.

© Copyright

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 HKAS 39 and are within the scope of HKAS 32[*] and 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 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 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,

© Copyright

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 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 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 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, HKAS 18 applies. Under HKAS 18, revenue associated with a transaction involving the rendering of services is recognised 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 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 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.

---

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

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.

© Copyright

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

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.

© Copyright

Appendix E

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs 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.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

Paragraphs 3 and 45 are amended and paragraph 41C is added as follows:

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 in the transitional provisions in paragraph 45.

45 Notwithstanding paragraph 4.9 of HKFRS 9, w~~W~~hen an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as measured ~~'~~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.

41C HKFRS 9, issued in November 2009, amended paragraphs 3 and 45. An entity shall apply those amendments when it applies HKFRS 9.

HKFRS 4 BC
~~Issued August 2004~~ Revised February 2010

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by IASCF. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

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.

CONTENTS

paragraphs

BASIS FOR CONCLUSIONS ON IFRS 4 *INSURANCE CONTRACTS*

INTRODUCTION	**BC1-BC9**
Background	**BC2-BC5**
Tentative conclusions for phase II	**BC6-BC9**
SCOPE	**BC10-BC76**
Definition of insurance contract	**BC11-BC60**
Insurance risk	BC21-BC24
Insurable interest	BC25-BC29
Quantity of insurance risk	BC30-BC37
Expiry of insurance-contingent rights and obligations	BC38-BC39
Unbundling	BC40-BC54
Weather derivatives	BC55-BC60
Scope exclusions	**BC61-BC76**
Financial guarantees and insurance against credit risk	BC62
Product warranties	BC69-BC72
Accounting by policyholders	BC73
Prepaid service contracts	BC74-BC76
TEMPORARY EXEMPTION FROM SOME OTHER IFRSs	**BC77-BC122**
Catastrophe and equalisation provisions	**BC87-BC93**
Liability adequacy	**BC94-BC104**
Derecognition	**BC105**
Offsetting	**BC106**
Reinsurance assets	**BC107-BC114**
Impairment of reinsurance assets	BC107-BC108
Gains and losses on buying reinsurance	BC109-BC114
Other existing practices	**BC115-BC122**
Acquisition costs	BC116-BC119

Salvage and subrogation BC120-BC121

Policy loans BC122

CHANGES IN ACCOUNTING POLICIES BC123-BC146

Relevance and reliability BC123-BC125

Discounting BC126-BC127

Investment management fees BC128-BC130

Uniform accounting policies on consolidation BC131-BC132

Excessive prudence BC133

Future investment margins BC134-BC144

Future investment margins and embedded value BC138-BC144

Redesignation of financial assets BC145-BC146

ACQUISITION OF INSURANCE CONTRACTS IN BUSINESS COMBINATIONS AND PORTFOLIO TRANSFERS BC147-BC153

DISCRETIONARY PARTICIPATION FEATURES BC154-BC165

ISSUES RELATED TO IAS 39 BC166-BC197

Assets held to back insurance contracts BC166-BC180

Shadow accounting BC181-BC184

Investment contracts BC185-BC187

Embedded derivatives BC188-BC194

Elimination of internal items BC195-BC197

INCOME TAXES BC198

DISCLOSURE BC199-BC226

Materiality BC208-BC210

Explanation of recognised amounts BC211-BC214

Assumptions BC211-BC213

Changes in insurance liabilities BC214

Nature and extent of risks arising from insurance contracts BC215-BC223

Insurance risk BC217

Sensitivity analysis BC218-BC219

Claims development BC220-BC221

Probable maximum loss BC222

Exposures to interest rate risk or market risk BC223

Fair value of insurance liabilities and insurance assets BC224-BC226

SUMMARY OF CHANGES FROM ED 5 BC227

DISSENTING OPINIONS

APPENDIX

Amendments resulting from other Basis for Conclusions

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.

© Copyright

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

(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* 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 IFRS deals with insurance contracts of all entities and does not address other aspects of accounting by insurers:

[*] 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*.

(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.

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.

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

* '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.

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.

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).

© Copyright

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.

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

[*] 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.'

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.

© Copyright

(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 contact 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 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.

(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 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 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:

© Copyright

(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, 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'.

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).

© Copyright

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

© Copyright

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

[*] ED 5 described this as a 'loss recognition test'

© Copyright

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 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.

© Copyright

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).

© Copyright

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.

(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 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.

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).

[*] 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.

(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).

(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.

© Copyright

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.

[*] This approach is consistent with the discussion of servicing rights and obligations in IAS 39.

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 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 prejudges 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).

© Copyright

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.[δ] 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.

---

[*] 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.

[δ] If embedded values are recognised in the ~~balance sheet~~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'.

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 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.

© Copyright

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 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.

© Copyright

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 prejudge 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.

© Copyright

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 ~~accumulated profits~~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.

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.

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. 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.

[*] In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended 'minority interests' to 'non-controlling interests'.

[†] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

(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 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.

[*] 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.

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.

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

---

[*] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

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.

(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.

© Copyright

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

© Copyright

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.

* The amendments contained in paragraph C12 are now incorporated as paragraphs 32A-32C of IAS 40.

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 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 orunrealised 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.

† 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.

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.

© Copyright

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.

(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.

© Copyright

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 66). This presentation does not result in the recognition of new assets and liabilities.

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.

* but included in this volume.

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.

(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.

---

[*] 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).

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.

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.

---

[*] 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.*

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.

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.

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).

© Copyright

(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 paragraph C8 of the IFRS).

Dissenting opinions on IFRS 4

DO1 Professor Barth and Messrs Garnett, Gélard, Leisenring, Smith and Yamada dissent from the issue of IFRS 4.

Dissent of Mary E Barth, Robert P Garnett, Gilbert Gélard, James J Leisenring and John T Smith

DO2 Messrs Garnett and Gélard 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, Gélard, 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.

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 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.

© Copyright

Appendix
Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In paragraph BC11 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*', in paragraphs BC22(c) and BC146 the first reference to 'IAS 39' and in paragraphs BC28(b), BC40, BC41(b), BC55, BC73(d) and BC82 the references to 'IAS 39' are footnoted as follows:

> * In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39. This paragraph discusses matters relevant when IFRS 4 was issued.

In paragraphs BC47 and BC161 the reference to 'IAS 39' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, amended the requirements in IAS 39 to identify and separately account for derivatives embedded in a financial host within the scope of IFRS 9. The requirements in IAS 39 continue to apply for derivatives embedded in non-financial hosts and financial hosts outside the scope of IFRS 9. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

In paragraph BC145(b) 'available-for-sale' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

The heading 'Issues related to IAS 39' above paragraph BC166 is footnoted as follows:

> * In November 2009 the IASB amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39. Paragraphs BC166–BC194 discuss matters relevant when IFRS 4 was issued.

In the dissenting opinions on IFRS 4 the headings above paragraphs DO7, DO9 and DO18 are footnoted as follows:

> * In November 2009 the IASB amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

HKFRS 4 Revised IG
~~Issued March 2006~~Revised February 2010

Revised Guidance on Implementing HKFRS 4

Insurance Contracts

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by IASCF. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

CONTENTS

paragraphs

GUIDANCE ON IMPLEMENTING IFRS 4 *INSURANCE CONTRACTS*

INTRODUCTION	**IG1**
DEFINITION OF INSURANCE CONTRACT	**IG2**
EMBEDDED DERIVATIVES	**IG3–IG4**
UNBUNDLING A DEPOSIT COMPONENT	**IG5**
SHADOW ACCOUNTING	**IG6–IG10**
DISCLOSURE	**IG11–IG71**
Purpose of this guidance	**IG11–IG14**
Materiality	**IG15–IG16**
Explanation of recognised amounts	**IG17–IG40**
Accounting policies	IG17–IG18
Assets, liabilities, income and expense	IG19–IG30
Significant assumptions and other sources of estimation uncertainty	IG31–IG33
Changes in assumptions	IG34–IG36
Changes in insurance liabilities and related items	IG37–IG40
Nature and extent of risks arising from insurance contracts	**IG41–IG71**
Risk management objectives and policies for mitigating risks arising from insurance contracts	IG48
Insurance risk	IG51–IG51A
Sensitivity to insurance risk	IG52–IG54A
Concentrations of insurance risk	IG55–IG58
Claims development	IG59–IG61
Credit risk, liquidity risk and market risk	IG62–IG65G
Credit risk	IG64A–IG65A
Liquidity risk	IG65B–IG65C
Market risk	IG65D–IG65G
Exposures to market risk under embedded derivatives	IG66–IG70

Key performance indicators **IG71**

IG EXAMPLES *after paragraph*

1 Application of the definition of an insurance contract **IG2**

2 Embedded derivatives **IG4**

3 Unbundling a deposit component of a reinsurance contract **IG5**

4 Shadow accounting **IG10**

5 Disclosure of claims development **IG61**

APPENDIX

Amendments resulting from other Implementation Guidance

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.

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 *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).

1.8	Investment contract[(a)] that does not contain a discretionary participation feature.	Within the scope of 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 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 IAS 39. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph AG33(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 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 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 IAS 39 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* 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 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).

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 *Provisions, Contingent Liabilities and Contingent Assets*.
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 IAS 39. Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 *Leases*.
1.16	Product warranties issued directly by a manufacturer, dealer or retailer.	Insurance contracts, but excluded from the scope of the IFRS (see 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 instrument within the scope of IAS 39. Servicing fees are within the scope of IAS 18 (recognise 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. 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 IAS 39 to it. (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 *Employee Benefits*, 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).
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.
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 *Consolidated and Separate Financial Statements*). 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 *Financial Instruments: Disclosures*, the reference to IAS 32 is replaced by a reference to IFRS 7.

Embedded derivatives

IG3 IAS 39 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 AG33(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 AG33(b) of IAS 39).

		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 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 AG33(b) of IAS 39).	Fair value measurement is required (paragraph 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 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 AG33(b) of IAS 39).

	(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.

2.9	Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder can benefit from the guarantee only by taking the annuity option (whether annuity rates are set at inception or at the date of annuitisation). 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).
2.10	Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment, (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates prevailing at the **date of annuitisation.**	If the guaranteed payments are not contingent to a significant extent on survival, the option to take the life-contingent annuity does not transfer insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract and is not closely related to the host insurance contract. Fair value measurement is required. If the guaranteed payments are contingent to a significant extent on survival, the guarantee is an insurance contract (similar to a pure endowment). Fair value measurement is not required (but not prohibited).	Fair value measurement is required.
2.11	Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates set at **inception.**	The whole contract is an insurance contract from inception (unless the life-contingent payments are insignificant). The option to take the life-contingent annuity is an embedded insurance contract, so fair value measurement is not required (but not prohibited). The option to take the cash payment or the period-certain annuity ('the second option') is not an insurance contract (unless the option is contingent to a significant extent on survival), so it must be separated. However, because the second option and the life-contingent option	Not applicable.

		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 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 AG30(d) and (e) of IAS 39).	Fair value measurement is required (paragraph AG30(d) and (e) of IAS 39).
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 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 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 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).
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.

continued…

…continued

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 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component. 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	4.10	(45.00)	0.00
Total		11.50	(11.50)	

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	31	41	156	0	(150)	6	6
		106	156		(150)			

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	0	0	(6)	(45)	39	27
Total	106	(150)	(6)	(45)	(5)	(35)

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 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.

continued...

…continued

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	1	(45)	39	0
Total		(18)	(12)	30	

(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 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 ~~Standard or Interpretation~~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 ~~2005~~20X5, insurer A measured financial assets on a cost basis. (Therefore, EGP under those accounting requirements considers only realised gains and losses.) However, under IFRSs, it classifies its financial assets as available for sale. Thus, insurer A measures the assets at fair value and recognises changes in their fair value ~~directly in equity, through the statement of changes in equity~~in other comprehensive income. In ~~2005~~20X5, insurer A recognises unrealised gains of CU10 on the assets backing the contract.

In ~~2006~~20X6, insurer A sells the assets for an amount equal to their fair value at the end of ~~2005~~ 20X5 and, to comply with IAS 39, ~~transfers~~ 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 ~~2005~~ 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 equity~~in other comprehensive income, it recognises the additional amortisation of CU2 ~~directly in equity, through the statement of changes in equity~~in other comprehensive income.

When insurer A sells the assets in ~~2006~~20X6, it makes no further adjustment to DAC, but ~~transfers~~ 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 equity~~in other comprehensive income rather than in profit or loss and (b) ~~transferred~~ 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 ~~a Standard or an Interpretation~~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 ~~of users taken~~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.

(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 flow~~s statement~~ 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~~ on the face of~~ in the ~~balance sheet~~statement of financial position. An insurer might conclude that, to satisfy those requirements, it needs to present separately~~ on the face of~~ in its ~~balance sheet~~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~~ on the face of~~ in the ~~balance sheet~~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~~ on the face of~~ in the ~~balance sheet~~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 1~~5~~4 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 ~~on the face of~~ in its statement of comprehensive income ~~statement~~. 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 ~~disclose~~ present the following amounts ~~on the face of~~ in its statement of comprehensive income ~~statement~~:

(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 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. Although revenue from insurance contracts is outside the scope of 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~~ on the face of~~ in its statement of comprehensive income ~~statement~~ 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 ~~income~~ statement of comprehensive income, or ~~as a complement to an income statement presented in a more traditional format~~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 ~~116-122~~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 ~~120~~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 ~~IAS 14 *Segment Reporting*~~IFRS 8 *Operating Segments*, the identification of reportable segments reflects ~~differences in the risks and returns of an entity's products and services~~the way in which management allocates resources and assesses performance. ~~IAS 14 takes the position that the segments identified in an organisational and management structure and internal financial reporting system normally provide an appropriate segmentation for financial reporting.~~ 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 ~~IAS 14~~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 ~~on the balance sheet~~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 [Deleted]

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 ~~reporting date~~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.~~ The guidance in IAS 14 may help an insurer to identify these.~~

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 insurers 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 ~~balance sheet~~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 ~~balance sheet~~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 ~~balance sheet~~statement of financial position.

Underwriting Year	20X1	20X2	20X3	20X4	20X5	Total
	CU	CU	CU	CU	CU	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	(702)	(689)	(570)	(350)	(217)	
	-	82	275	553	751	1,661
Effect of discounting	-	(14)	(68)	(175)	(285)	(542)
Present value recognised in the ~~balance sheet~~ statement of financial position	-	68	207	378	466	1,119

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 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 ~~balance sheet~~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 ~~analysis~~ 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 ~~balance sheet~~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 ~~reporting date~~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.

Appendix
Amendments resulting from other Implementation Guidance

The following sets out amendments required for this guidance resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In the table in IG Example 1, the 'Treatment in Phase I' column of contract type 1.18 is amended as follows:

Insurance risk is insignificant. Therefore, the contract is a financial ~~instrument~~ asset within the scope of ~~IAS 39~~IFRS 9. Servicing fees are within the scope of IAS 18 (recognise as services are provided, subject to various conditions).

IG Example 4 in paragraph IG10 is amended as follows:

IG Example 4: Shadow accounting

Background

...

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 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 ~~I~~in 20X6~~,~~ ~~insurer A~~ it 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 ~~other comprehensive income~~ profit or loss.

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.'

HKFRS 5
Revised ~~May 2009~~ February 2010

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by International Accounting Standards Committee Foundation. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

CONTENTS

	paragraphs
INTRODUCTION	**IN1-IN6**
HONG KONG FINANCIAL REPORTING STANDARD 5	
NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS	
OBJECTIVE	**1**
SCOPE	**2-5B**
CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE OR AS HELD FOR DISTRIBUTION TO OWNERS	**6-14**
Non-current assets that are to be abandoned	**13-14**
MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE	**15-29**
Measurement of a non-current asset (or disposal group)	**15-19**
Recognition of impairment losses and reversals	**20-25**
Changes to a plan of sale	**26-29**
PRESENTATION AND DISCLOSURE	**30-42**
Presenting discontinued operations	**31-36A**
Gains or losses relating to continuing operations	**37**
Presentation of a non-current asset or disposal group classified as held for sale	**38-40**
Additional disclosures	**41-42**
TRANSITIONAL PROVISIONS	**43**
EFFECTIVE DATE	**44-44E**
WITHDRAWAL OF SSAP 33	**45**

APPENDICES

A Defined terms

B Application supplement

Extension of the period required to complete a sale

C Amendments to other HKFRSs

D Comparison with International Financial Reporting Standards

E Amendments resulting from other HKFRSs

© Copyright

BASIS FOR CONCLUSIONS

DISSENTING OPINIONS

IMPLEMENTATION GUIDANCE

Hong Kong Financial Reporting Standard 5 *Non-current Assets Held for Sale and Discontinued Operations* (HKFRS 5) is set out in paragraphs 1-45 and Appendices A-C and E. 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 5 should be read in the context of its objective and the Basis for Conclusions, 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.

Introduction

Reasons for issuing the HKFRS

IN1 Hong Kong Financial Reporting Standard 5 *Non-current Assets Held for Sale and Discontinued Operations* (HKFRS 5) sets out requirements for the classification, measurement and presentation of non-current assets held for sale and replaces SSAP 33 *Discontinuing Operations*.

IN2 Hong Kong Institute of Certified Public Accountants has a policy of achieving convergence of HKFRSs with International Financial Accounting Standards (IFRSs). Achieving convergence of accounting standards around the world is one of the prime objectives of the International Accounting Standards Board. In pursuit of that objective, one of the strategies adopted by the Board has been to enter into a memorandum of understanding with the Financial Accounting Standards Board (FASB) in the United States that sets out the two boards' commitment to convergence. As a result of that understanding the boards have undertaken a joint short-term project with the objective of reducing differences between IFRSs and US GAAP that are capable of resolution in a relatively short time and can be addressed outside major projects.

IN3 One aspect of that project involves the two boards considering each other's recent standards with a view to adopting high quality accounting solutions. IFRS 5 arises from the IASB's consideration of FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), issued in 2001.

IN4 SFAS 144 addresses three areas: (i) the impairment of long-lived assets to be held and used, (ii) the classification, measurement and presentation of assets held for sale and (iii) the classification and presentation of discontinued operations. The impairment of long-lived assets to be held and used is an area in which there are extensive differences between IFRSs and US GAAP. However, those differences were not thought to be capable of resolution in a relatively short time. Convergence on the other two areas was thought to be worth pursuing within the context of the short-term project.

IN5 IFRS 5 achieves substantial convergence with the requirements of SFAS 144 relating to assets held for sale, the timing of the classification of operations as discontinued and the presentation of such operations. The HKFRS is converged with IFRS 5.

Main features of the HKFRS

IN6 The HKFRS:

(a) adopts the classification 'held for sale'.

(b) introduces the concept of a disposal group, being a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

(c) specifies that assets or disposal groups that are classified as held for sale are carried at the lower of carrying amount and fair value less costs to sell.

© Copyright

(d) specifies that an asset classified as held for sale, or included within a disposal group that is classified as held for sale, is not depreciated.

(e) specifies that an asset classified as held for sale, and the assets and liabilities included within a disposal group classified as held for sale, are presented separately ~~on the face of the balance sheet~~in the statement of financial position.

(f) withdraws SSAP 33 *Discontinuing Operations* and replaces it with requirements that:

   (i) change the timing of the classification of an operation as discontinued. SSAP 33 classified an operation as discontinuing at 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. The HKFRS classifies an operation as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation.

   (ii) specify that the results of discontinued operations are to be shown separately ~~on the face of the income statement~~in the statement of comprehensive income.

   (iii) prohibit retroactive classification of an operation as discontinued, when the criteria for that classification are not met until after the ~~balance sheet date~~ reporting date.

Hong Kong Financial Reporting Standard 5

Non-current Assets Held for Sale and Discontinued Operations

Objective

1 The objective of this HKFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of *discontinued operations*. In particular, the HKFRS requires:

(a) assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and *fair value* less *costs to sell,* and depreciation on such assets to cease; and

(b) assets that meet the criteria to be classified as held for sale to be presented separately ~~on the face of the balance sheet~~in the statement of financial position and the results of discontinued operations to be presented separately in the ~~income statement~~statement of comprehensive income.

Scope

2 The classification and presentation requirements of this HKFRS apply to all recognised *non-current assets*[*] and to all *disposal groups* of an entity. The measurement requirements of this HKFRS apply to all recognised non-current assets and disposal groups (as set out in paragraph 4), except for those assets listed in paragraph 5 which shall continue to be measured in accordance with the Standard noted.

3 Assets classified as non-current in accordance with HKAS 1 *Presentation of Financial Statements* shall not be reclassified as *current assets* until they meet the criteria to be classified as held for sale in accordance with this HKFRS. Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current unless they meet the criteria to be classified as held for sale in accordance with this HKFRS.

4 Sometimes an entity disposes of a group of assets, possibly with some directly associated liabilities, together in a single transaction. Such a disposal group may be a group of *cash-generating units*, a single cash-generating unit, or part of a cash-generating unit.[**] The group may include any assets and any liabilities of the entity, including current assets, current liabilities and assets excluded by paragraph 5 from the measurement requirements of this HKFRS. If a non-current asset within the scope of the measurement requirements of this HKFRS is part of a disposal group, the measurement requirements of this HKFRS apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell.

[*] For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the ~~balance sheet date~~ reporting period. Paragraph 3 applies to the classification of such assets.

[**] However, once the cash flows from an asset or group of assets are expected to arise principally from sale rather than continuing use, they become less dependent on cash flows arising from other assets, and a disposal group that was part of a cash-generating unit becomes a separate cash-generating unit.

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 ~~Standards~~ 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 *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 ~~estimated point of sale~~ 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.

7 For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be *highly probable*.

8[*] For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

8A[*] An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out in paragraphs 6-8 are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

9 Events or circumstances may extend the period to complete the sale beyond one year. An extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). This will be the case when the criteria in Appendix B are met.

10 Sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance in accordance with HKAS 16 *Property, Plant and Equipment*.

11 When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify the non-current asset (or disposal group) as held for sale at the acquisition date only if the one-year requirement in paragraph 8 is met (except as permitted by paragraph 9) and it is highly probable that any other criteria in paragraphs 7 and 8 that are not met at that date will be met within a short period following the acquisition (usually within three months).

12 If the criteria in paragraphs 7 and 8 are met after the ~~balance sheet date~~ reporting period, an entity shall not classify a non-current asset (or disposal group) as held for sale in those financial statements when issued. However, when those criteria are met after the ~~balance sheet date~~ reporting period but before the authorisation of the financial statements for issue, the entity shall disclose the information specified in paragraph 41(a), (b) and (d) in the notes.

12A[*] A non-current asset (or disposal group) is classified as held for distribution to owners when the entity is committed to distribute the asset (or disposal group) to the owners. For this to be the case, the assets must be available for immediate distribution in their present condition and the distribution must be highly probable. For the distribution to be highly probable, actions to complete the distribution must have been initiated and should be expected to be completed within one year from the date of classification. Actions required to complete the distribution should indicate that it is unlikely that

[*] Effective for annual periods beginning on or after 1 July 2009.

significant changes to the distribution will be made or that the distribution will be withdrawn. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the distribution is highly probable.

Non-current assets that are to be abandoned

13 An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use. However, if the disposal group to be abandoned meets the criteria in paragraph 32(a)-(c), the entity shall present the results and cash flows of the disposal group as discontinued operations in accordance with paragraphs 33 and 34 at the date on which it ceases to be used. Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold.

14 An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned.

Measurement of non-current assets (or disposal groups) classified as held for sale

Measurement of a non-current asset (or disposal group)

15 An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

15A[‡] An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the lower of its carrying amount and fair value less costs to distribute.[*]

16 If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale (see paragraph 11), applying paragraph 15 will result in the asset (or disposal group) being measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell. Hence, if the asset (or disposal group) is acquired as part of a business combination, it shall be measured at fair value less costs to sell.

17 When the sale is expected to occur beyond one year, the entity shall measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.

18 Immediately before the initial classification of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) shall be measured in accordance with applicable HKFRSs.

‡ Effective for annual periods beginning on or after 1 July 2009.

* Costs to distribute are the incremental costs directly attributable to the distribution, excluding finance costs and income tax expense.

19 On subsequent remeasurement of a disposal group, the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of this HKFRS, but are included in a disposal group classified as held for sale, shall be remeasured in accordance with applicable HKFRSs before the fair value less costs to sell of the disposal group is remeasured.

Recognition of impairment losses and reversals

20 An entity shall recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell, to the extent that it has not been recognised in accordance with paragraph 19.

21 An entity shall recognise a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognised either in accordance with this HKFRS or previously in accordance with HKAS 36 *Impairment of Assets*.

22 An entity shall recognise a gain for any subsequent increase in fair value less costs to sell of a disposal group:

(a) to the extent that it has not been recognised in accordance with paragraph 19; but

(b) not in excess of the cumulative impairment loss that has been recognised, either in accordance with this HKFRS or previously in accordance with HKAS 36, on the non-current assets that are within the scope of the measurement requirements of this HKFRS.

23 The impairment loss (or any subsequent gain) recognised for a disposal group shall reduce (or increase) the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of this HKFRS, in the order of allocation set out in paragraphs 104(a) and (b) and 122 of HKAS 36.

24. A gain or loss not previously recognised by the date of the sale of a non-current asset (or disposal group) shall be recognised at the date of derecognition. Requirements relating to derecognition are set out in:

(a) paragraphs 67-72 of HKAS 16 for property, plant and equipment, and

(b) paragraphs 112-117 of HKAS 38 *Intangible Assets* for intangible assets.

25 An entity shall not depreciate (or amortise) a non-current asset while it is classified as held for sale or while it is part of a disposal group classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be recognised.

Changes to a plan of sale

26 If an entity has classified an asset (or disposal group) as held for sale, but the criteria in paragraphs 7-9 are no longer met, the entity shall cease to classify the asset (or disposal group) as held for sale.

© Copyright

27 The entity shall measure a non-current asset that ceases to be classified as held for sale (or ceases to be included in a disposal group classified as held for sale) at the lower of:

(a) its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale, and

(b) its *recoverable amount* at the date of the subsequent decision not to sell.[*]

28 The entity shall include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in income[δ] from continuing operations in the period in which the criteria in paragraphs 7-9 are no longer met. The entity shall present that adjustment ~~in the same income statement caption~~in the same caption in the statement comprehensive income used to present a gain or loss, if any, recognised in accordance with paragraph 37.

29 If an entity removes an individual asset or liability from a disposal group classified as held for sale, the remaining assets and liabilities of the disposal group to be sold shall continue to be measured as a group only if the group meets the criteria in paragraphs 7-9. Otherwise, the remaining non-current assets of the group that individually meet the criteria to be classified as held for sale shall be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date. Any non-current assets that do not meet the criteria shall cease to be classified as held for sale in accordance with paragraph 26.

Presentation and disclosure

30 An entity shall 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).

Presenting discontinued operations

31 A *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use.

32 A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and

(a) represents a separate major line of business or geographical area of operations,

[*] If the non-current asset is part of a cash-generating unit, its recoverable amount is the carrying amount that would have been recognised after the allocation of any impairment loss arising on that cash-generating unit in accordance with HKAS 36.

[δ] Unless the asset is property, plant and equipment or an intangible asset that had been revalued in accordance with HKAS 16 or HKAS 38 before classification as held for sale, in which case the adjustment shall be treated as a revaluation increase or decrease.

© Copyright

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

33 An entity shall disclose:

(a) a single amount ~~on the face of the income statement~~in the statement of comprehensive income comprising the total of:

(i) the post-tax profit or loss of discontinued operations and

(ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

(b) an analysis of the single amount in (a) into:

(i) the revenue, expenses and pre-tax profit or loss of discontinued operations;

(ii) the related income tax expense as required by paragraph 81(h) of HKAS 12;

(iii) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and

(iv) the related income tax expense as required by paragraph 81(h) of HKAS 12.

The analysis may be presented in the notes or ~~on the face of the income statement~~ in the statement of comprehensive income. If it is presented ~~on the face of the income statement~~ in the statement of comprehensive income it shall be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. The analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition (see paragraph 11).

(c) the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either in the notes or ~~on the face of~~ in the financial statements. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition (see paragraph 11).

(d)* the amount of income from continuing operations and from discontinued operations attributable to owners of the parent. These disclosures may be presented either in the notes or in the statement of comprehensive income.

33A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of IAS 1 (as revised in 2007), a section identified as relating to discontinued operations is presented in that separate statement.

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

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 ~~balance sheet date~~ 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 ~~balance sheet~~ statement of financial position. The liabilities of a disposal group classified as held for sale shall be presented separately from other liabilities in the ~~balance sheet~~ 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 ~~on the face of the balance sheet~~ in he 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 directly in equity~~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.

39 If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition (see paragraph 11), disclosure of the major classes of assets and liabilities is not required.

40 **An entity shall not reclassify or re-present amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the ~~balance sheets~~ statement of financial position for prior periods to reflect the classification in the ~~balance sheet~~ statement of financial position for the latest period presented.**

Additional disclosures

41 **An entity shall disclose the following information in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:**

(a) **a description of the non-current asset (or disposal group);**

(b) **a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;**

(c) **the gain or loss recognised in accordance with paragraphs 20-22 and, if not separately presented ~~on the face of the income statement~~ in the statement of comprehensive income, the caption in the ~~income statement~~ statement of comprehensive income that includes that gain or loss;**

(d) **if applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with ~~HKAS 14 *Segment Reporting*~~HKFRS 8 *Operating Segments*.**

42 **If either paragraph 26 or paragraph 29 applies, an entity shall disclose, in the period of the decision to change the plan to sell the non-current asset (or disposal group), a description of the facts and circumstances leading to the decision and the effect of the decision on the results of operations for the period and any prior periods presented.**

Transitional provisions

43 **The HKFRS shall be applied prospectively to non-current assets (or disposal groups) that meet the criteria to be classified as held for sale and operations that meet the criteria to be classified as discontinued after the effective date of the HKFRS. An entity may apply the requirements of the HKFRS to all non-current assets (or disposal groups) that meet the criteria to be classified as held for sale and operations that meet the criteria to be classified as discontinued after any date before the effective date of the HKFRS, provided the valuations and other information needed to apply the HKFRS were obtained at the time those criteria were originally met.**

Effective date

44 **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.**

44A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 3 and 38, and added paragraph 33A. 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* 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.

Withdrawal of ssap 33

45 This HKFRS supersedes SSAP 33 *Discontinuing Operations*.

* Effective for annual periods beginning on or after 1 July 2009.
+ Effective for annual periods beginning on or after 1 January 2010.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

cash-generating unit

The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

component of an entity

Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

costs to sell

The incremental costs directly attributable to the disposal of an asset (or **disposal group**), excluding finance costs and income tax expense.

current asset

An entity shall classify an asset as current when~~that satisfies any of the following criteria~~:

(a) it ~~is~~ expects~~ed~~ to ~~be~~ realise~~d in~~ the asset, or ~~is~~ intends~~ed for sale~~ to sell or consume~~ption~~ it, in~~, the entity's~~ its normal operating cycle;

(b) it ~~is held~~ holds the asset primarily for the purpose of ~~being~~ trading~~ed~~;

(c) it ~~is~~ expects~~ed~~ to ~~be~~ realise~~d~~ the asset within twelve months after the ~~balance sheet date~~reporting period; or

(d) ~~it~~the asset is cash or a cash equivalent (as defined in HKAS 7) unless ~~it~~the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the ~~balance sheet date~~reporting period.

discontinued operation

A **component of an entity** that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations,

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

© Copyright

disposal group	A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a **cash-generating unit** to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of HKAS 36 *Impairment of Assets* or if it is an operation within such a cash-generating unit.
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
firm purchase commitment	An agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance **highly probable**.
highly probable	Significantly more likely than **probable**.
non-current asset	An asset that does not meet the definition of a **current asset**.
probable	More likely than not.
recoverable amount	The higher of an asset's **fair value** less **costs to sell** and its **value in use**.
value in use	The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

© Copyright

Appendix B
Application supplement

This appendix is an integral part of the HKFRS.

Extension of the period required to complete a sale

B1 As noted in paragraph 9, an extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). An exception to the one-year requirement in paragraph 8 shall therefore apply in the following situations in which such events or circumstances arise:

(a) at the date an entity commits itself to a plan to sell a non-current asset (or disposal group) it reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (or disposal group) that will extend the period required to complete the sale, and:

(i) actions necessary to respond to those conditions cannot be initiated until after a *firm purchase commitment* is obtained, and

(ii) a firm purchase commitment is highly probable within one year.

(b) an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classified as held for sale that will extend the period required to complete the sale, and:

(i) timely actions necessary to respond to the conditions have been taken, and

(ii) a favourable resolution of the delaying factors is expected.

(c) during the initial one-year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group) previously classified as held for sale is not sold by the end of that period, and:

(i) during the initial one-year period the entity took action necessary to respond to the change in circumstances,

(ii) the non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances, and

(iii) the criteria in paragraphs 7 and 8 are met.

© Copyright

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 applies 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.

© Copyright

Appendix D

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 5.

The International Financial Reporting Standard comparable with HKFRS 5 is IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations.*

There are no major textual differences between HKFRS 5 and IFRS 5.

© Copyright

Appendix E

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs 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.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In paragraph 5(c), the reference to 'HKAS 39 *Financial Instruments: Recognition and Measurement*' is replaced with 'HKFRS 9 *Financial Instruments*'.

HKFRS 5 BC

~~Issued August 2004~~Revised February 2010

Basis for Conclusions on
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

HKFRS 5 is based on IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. In approving HKFRS 5, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 5. Accordingly, there are no significant differences between HKFRS 5 and IFRS 5. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 5 referred to below generally correspond with those in HKFRS 5.

CONTENTS

paragraphs

BASIS FOR CONCLUSIONS
HKFRS 5 *NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS*

INTRODUCTION	**BC1-BC7**
SCOPE OF THE IFRS	**BC8-BC14E**
CLASSIFICATION OF NON-CURRENT ASSETS TO BE DISPOSED OF AS HELD FOR SALE	**BC15-BC27**
Plan to sell the controlling interest in a subsidiary	**BC24A-BC24E**
Assets to be exchanged for other non-current assets	**BC25-BC27**
MEASUREMENT OF NON-CURRENT ASSETS HELD FOR SALE	**BC28-BC51**
The allocation of an impairment loss to a disposal group	**BC39-BC41**
Newly acquired assets	**BC42-BC45**
Recognition of subsequent increases in fair value less costs to sell	**BC46**
Recognition of impairment losses and subsequent gains for assets that, before classification as held for sale, were measured at revalued amounts in accordance with another IFRS	**BC47-BC48**
Measurement of assets reclassified as held for use	**BC49-BC51**
REMOVAL OF EXEMPTION FROM CONSOLIDATION FOR SUBSIDIARIES ACQUIRED AND HELD EXCLUSIVELY WITH A VIEW TO RESALE	**BC52-BC55**
PRESENTATION OF NON-CURRENT ASSETS HELD FOR SALE	**BC56-BC58**
TIMING OF CLASSIFICATION AS, AND DEFINITION OF, DISCONTINUED OPERATIONS	**BC59-BC72**
PRESENTATION OF DISCONTINUED OPERATIONS	**BC73-BC77**
TRANSITIONAL ARRANGEMENTS	**BC78-BC79**
TERMINOLOGY	**BC80-BC83**
SUMMARY OF CHANGES FROM ED 4	**BC84**
COMPARISON WITH RELEVANT ASPECTS OF SFAS 144	**BC85**

DISSENTING OPINIONS

APPENDIX

Amendments resulting from other Basis for Conclusions

Basis for Conclusions on IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

This Basis for Conclusions accompanies, but is not part of, IFRS 5.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Individual Board members gave greater weight to some factors than to others.

BC2 In September 2002 the Board agreed to add a short-term convergence project to its active agenda. The objective of the project is to reduce differences between IFRSs and US GAAP that are capable of resolution in a relatively short time and can be addressed outside major projects. The project is a joint project with the US Financial Accounting Standards Board (FASB).

BC3 As part of the project, the two boards agreed to review each other's deliberations on each of the selected possible convergence topics, and choose the highest quality solution as the basis for convergence. For topics recently considered by either board, there is an expectation that whichever board has more recently deliberated that topic will have the higher quality solution.

BC4 As part of the review of topics recently considered by the FASB, the Board discussed the requirements of SFAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*, as they relate to assets held for sale and discontinued operations. The Board did not consider the requirements of SFAS 144 relating to the impairment of assets held for use. Impairment of such assets is an issue that is being addressed in the IASB research project on measurement being led by the Canadian Accounting Standards Board.

BC5 Until the issue of IFRS 5, the requirements of SFAS 144 on assets held for sale and discontinued operations differed from IFRSs in the following ways:

(a) if specified criteria are met, SFAS 144 requires non-current assets that are to be disposed of to be classified as held for sale. Such assets are remeasured at the lower of carrying amount and fair value less costs to sell and are not depreciated or amortised. IFRSs did not require non-current assets that are to be disposed of to be classified separately or measured differently from other non-current assets.

(b) the definition of discontinued operations in SFAS 144 was different from the definition of discontinuing operations in IAS 35 *Discontinuing Operations* and the presentation of such operations required by the two standards was also different.

BC6 As discussed in more detail below, the Board concluded that introducing a classification of assets that are held for sale would substantially improve the information available to users of financial statements about assets to be sold.

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.

© Copyright

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

[*] The Board acknowledges that not all financial assets within the scope of IAS 39 are recognised at fair value with changes in fair value recognised in profit or loss but it did not want to make any further changes to the accounting for financial assets at this time.

[†] 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'.

[‡] Paragraphs BC14A-BC14E were added by *Improvements to IFRSs* issued in April 2009.

providing information about assets and groups of assets and liabilities to be disposed of is of benefit to users of financial statements. Such information should assist users in assessing the timing, amount and uncertainty of future cash flows.'

BC14C The Board noted that some IFRSs other than IFRS 5 require specific disclosures for non-current assets (or disposal groups) classified as held for sale or discontinued operations. For instance, paragraph 68 of IAS 33 *Earnings per Share* requires an entity to disclose the amount per share for discontinued operations. The board also noted that the requirements of IAS 1 on fair presentation and materiality also apply to such assets (or disposal groups).

BC14D The Board also noted that when a disposal group includes assets and liabilities that are not within the scope of the measurement requirements of IFRS 5, disclosures about measurement of those assets and liabilities are normally provided in the other notes to the financial statements and do not need to be repeated, unless they better enable users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

BC14E Consequently, in *Improvements to IFRSs* issued in April 2009, the Board clarified 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 assest or operations. Additional disclosures about non-current assets (or disposal groups) classified as held for sale may be necessary to comply with the general requirements of IAS 1, in particular paragraphs 15 and 125 of that Standard.

Classification of non-current assets to be disposed of as held for sale

BC15 Under SFAS 144, long-lived assets are classified as either (i) held and used or (ii) held for sale. Before the issue of this IFRS, no distinction was made in IFRSs between non-current assets held and used and non-current assets held for sale, except in relation to financial instruments.

BC16 The Board considered whether a separate classification for non-current assets held for sale would create unnecessary complexity in IFRSs and introduce an element of management intent into the accounting. Some commentators suggested that the categorisation 'assets held for sale' is unnecessary, and that if the focus were changed to 'assets *retired* from active use' much of the complexity could be eliminated, because the latter classification would be based on actuality rather than what they perceive as management intent. They assert that it is the potential abuse of the classification that necessitates many of the detailed requirements in SFAS 144. Others suggested that, if existing IFRSs were amended to specify that assets retired from active use are measured at fair value less costs to sell and to require additional disclosure, some convergence with SFAS 144 could be achieved without creating a new IFRS.

BC17 However, the Board concluded that providing information about assets and groups of assets and liabilities to be disposed of is of benefit to users of financial statements. Such information should assist users in assessing the timing, amount and uncertainty of future cash flows. The Board understands that this was also the assessment underpinning SFAS 144. Therefore the Board concluded that introducing the notion of assets and disposal groups held for sale makes IFRSs more complete.

BC18 Furthermore, although the held for sale classification begins from an intention to sell the asset, the other criteria for this classification are tightly drawn and are significantly more objective than simply specifying an intention or commitment to sell. Some might argue that the criteria are too specific. However, the Board believes that the criteria should be specific to achieve comparability of classification between entities. The Board does not believe that a classification 'retired from active use' would necessarily require fewer criteria to support it. For example, it would be necessary to establish a distinction between assets retired from active use and those that are held as back-up spares or are temporarily idle.

BC19 Lastly, if the classification and measurement of assets held for sale in IFRSs are the same as in US GAAP, convergence will have been achieved in an area of importance to users of financial statements.

BC20 Most respondents to ED 4 agreed that a separate classification for non-current assets that are no longer held to be used is desirable. However, the proposals in ED 4 were criticised for the following reasons:

(a) the criteria were too restrictive and rules-based.

(b) a commitment to sell needs to be demonstrated, consistently with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* relating to restructuring provisions.

(c) the classification should be for assets retired from active use.

(d) assets to be abandoned should be treated in the same way as assets to be sold.

BC21 The Board noted that a more flexible definition would be open to abuse. Further, changing the criteria for classification could cause divergence from US GAAP. The Board has, however, reordered the criteria to highlight the principles.

BC22 The Board also noted that the requirements of IAS 37 establish when a liability is incurred, whereas the requirements of the IFRS relate to the measurement and presentation of assets that are already recognised.

BC23 Finally, the Board reconfirmed the principle behind the classification proposals in ED 4, which is that the carrying amount of the assets will be recovered principally through sale. Applying this principle to assets retired from active use, the Board decided that assets retired from active use that do not meet the criteria for classification as assets held for sale should not be presented separately because the carrying amount of the asset may not be recovered principally through sale. Conversely, the Board decided that assets that meet the criteria to be classified as held for sale and are being used should not be precluded from being separately classified. This is because, if a non-current asset is available for immediate sale, the remaining use of the asset is incidental to its recovery through sale and the carrying amount of the asset will be recovered principally through sale.

BC24 Applying the same principle to assets to be abandoned, the Board noted that their carrying value will never be recovered principally through sale.

© Copyright

Plan to sell the controlling interest in a subsidiary*

BC24A In 2007 the Board considered situations in which an entity is committed to a plan to sell the controlling interest in a subsidiary and, after the sale, retains a non-controlling interest in its former subsidiary, taking the form of an investment in an associate, an investment in a joint venture or a financial asset. The Board considered how the classification as held for sale applies to the subsidiary in the consolidated financial statements of the entity.

BC24B The Board noted that paragraph 6 states that '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.' The Board also noted that IAS 27 *Consolidated and Separate Financial Statements* (as amended in January 2008) defines control and requires a parent to consolidate a subsidiary until control is lost. At the date control is lost, all the subsidiary's assets and liabilities are derecognised and any investment retained in the former subsidiary is recognised. Loss of control is a significant economic event that changes the nature of an investment. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.

BC24C The Board concluded that, under the sale plan described above, the controlling interest in the subsidiary is, in substance, exchanged for a non-controlling interest. Therefore, in the Board's view, being committed to a plan involving loss of control of a subsidiary should trigger classification as held for sale. The Board also noted that this conclusion is consistent with IAS 27.

BC24D The Board noted that the subsidiary's assets and liabilities meet the definition of a disposal group in accordance with paragraph 4. Therefore, the Board concluded that all the subsidiary's assets and liabilities should be classified as held for sale, not only the portion of the interest to be disposed of, regardless of whether the entity will retain a non-controlling interest.

BC24E The Board considered the comments received on the proposal set out in its exposure draft of October 2007. In response to comments from some respondents, the Board clarified in the amendment that the criteria for classification as held for sale need to be met.

Assets to be exchanged for other non-current assets

BC25 Under SFAS 144, long-lived assets that are to be exchanged for similar productive assets cannot be classified as held for sale. They are regarded as disposed of only when exchanged. The Basis for Conclusions on SFAS 144 explains that this is because the exchange of such assets is accounted for at amounts based on the carrying amount of the assets, not at fair value, and that using the carrying amount is more consistent with the accounting for a long-lived asset to be held and used than for a long-lived asset to be sold.

* This section and paragraphs BC77A and BC79A were added as a consequence of amendments to IFRS 5 by *Improvements to IFRSs* issued in May 2008.

BC26 Under IAS 16 *Property, Plant and Equipment*, as revised in 2003, an exchange of assets is normally measured at fair value. The SFAS 144 reasoning for the classification of such assets as held for sale does not, therefore, apply. Consistently with IAS 16, the IFRS treats an exchange of assets as a disposal and acquisition of assets unless the exchange has no commercial substance.

BC27 The FASB has published an exposure draft proposing to converge with the requirements in IAS 16 for an exchange of assets to be measured at fair value. The exposure draft also proposes a consequential amendment to SFAS 144 that would make exchanges of assets that have commercial substance eligible for classification as held for sale.

Measurement of non-current assets held for sale

BC28 SFAS 144 requires a long-lived asset or a disposal group classified as held for sale to be measured at the lower of its carrying amount and fair value less costs to sell. A long-lived asset classified as held for sale (or included within a disposal group) is not depreciated, but interest and other expenses attributable to the liabilities of a disposal group are recognised.

BC29 As explained in the Basis for Conclusions on SFAS 144, the remaining use in operations of an asset that is to be sold is incidental to the recovery of the carrying amount through sale. The accounting for such an asset should therefore be a process of valuation rather than allocation.

BC30 The FASB further observed that once the asset is remeasured, to depreciate the asset would reduce its carrying amount below its fair value less costs to sell. It also noted that should there be a decline in the value of the asset after initial classification as held for sale and before eventual sale, the loss would be recognised in the period of decline because the fair value less costs to sell is evaluated each period.

BC31 The counter-argument is that, although classified as held for sale, the asset is still being used in operations, and hence cessation of depreciation is inconsistent with the basic principle that the cost of an asset should be allocated over the period during which benefits are obtained from its use. Furthermore, although the decline in the value of the asset through its use would be reflected in the recognised change in fair value, it might also be masked by an increase arising from changes in the market prices of the asset.

BC32 However, the Board noted that IAS 16 requires an entity to keep the expected useful life and residual values of property. plant and equipment up to date, and IAS 36 *Impairment of Assets* requires an immediate write-down to the higher of value in use and fair value less costs to sell. An entity should, therefore, often achieve a measurement effect for individual assets that are about to be sold under other IFRSs similar to that required by this IFRS as follows. Under other IFRSs, if the fair value less costs to sell is higher than carrying amount there will be no impairment and no depreciation (because the residual value will have been updated). If fair value less costs to sell is lower than carrying amount, there will be an impairment loss that reduces the carrying amount to fair value less costs to sell and then no depreciation (because the residual value will have been updated), unless value in use is higher than fair value less costs to sell. If value in use is higher than fair value less costs to sell, there would be small differences between the treatment that would arise under other

© Copyright

IFRSs and the treatment under IFRS 5. Under other IFRSs there would be an impairment loss to the extent that the carrying amount exceeds value in use rather than to the extent that the carrying amount exceeds fair value less costs to sell. Under other IFRSs, there would also then be depreciation of the excess of value in use (the new carrying amount of the asset) over fair value less costs to sell (its residual value). However, for assets classified as held for sale, value in use will differ from fair value less costs to sell only to the extent of the net cash flows expected to arise before the sale. If the period to sale is short, this amount will usually be relatively small. The difference in impairment loss recognised and subsequent depreciation under other IFRSs compared with the impairment loss and no subsequent depreciation under IFRS 5 would, therefore, also be small.

BC33 The Board concluded that the measurement requirements of IFRS 5 for individual assets would often not involve a significant change from the requirements of other IFRSs. Furthermore, the Board agreed with the FASB that the cash flows arising from the asset's remaining use were incidental to the recovery of the asset through sale and, hence, concluded that individual assets classified as held for sale should be measured at the lower of carrying amount and fair value less costs to sell and should not be depreciated.

BC34 For disposal groups, there could be greater differences between the requirements in other IFRSs and the requirements of IFRS 5. For example, the fair value less costs to sell of a disposal group may reflect internally generated goodwill to the extent that it is higher than the carrying value of the net assets in the disposal group. The residual value of the non-current assets in the disposal group may, nonetheless, be such that, if they were accounted for in accordance with IAS 16, those assets would be depreciated.

BC35 In such a situation, some might view the requirements in IFRS 5 as allowing internally generated goodwill to stop the depreciation of non-current assets. However, the Board does not agree with that view. Rather, the Board believes that the internally generated goodwill provides a buffer against the recognition of an impairment loss on the disposal group. The same effect arises from the impairment requirements in IAS 36. The non-depreciation of the non-current assets in the disposal group is, as with individual assets, a consequence of the basic principle underlying the separate classification, that the carrying amount of the asset will be recovered principally through sale, not continuing use, and that amounts recovered through continuing use will be incidental.

BC36 In addition, it is important to emphasise that IFRS 5 permits only an asset (or disposal group) that is to be *sold* to be classified as held for sale. Assets to be abandoned are classified as held and used until disposed of, and thus are depreciated. The Board agrees with the FASB's observation that a distinction can be drawn between an asset that is to be sold and an asset that is to be abandoned, because the former will be recovered principally through sale and the latter through its continuing use. Therefore, it is logical that depreciation should cease in the former but not the latter case.

BC37 When an asset or a disposal group held for sale is part of a foreign operation with a functional currency that is different from the presentation currency of the group, an exchange difference will have been recognised in equity[*] arising from the translation of the asset or disposal group into the presentation currency of the group. IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires the exchange difference to be

[*] As a consequence of the revision of IAS 1 *Presentation of Financial Statements* (as revised in 2007) such a difference is recognised in other comprehensive income.

'recycled' from equity to profit or loss on disposal of the operation. The question arises whether classification as held for sale should trigger the recycling of any exchange differences. Under US GAAP (EITF 01-5 *Application of FASB Statement No. 52 to an Investment Being Evaluated for Impairment That Will Be Disposed Of*) the accumulated foreign currency translation adjustments previously recognised in other comprehensive income that are expected to be recycled in income at the time of sale are included in the carrying amount of the asset (or disposal group) being tested for impairment.

BC38 In its project on reporting comprehensive income, the Board may reconsider the issue of recycling. Therefore, it did not wish to make any interim changes to the requirements in IAS 21. Hence, the IFRS does not permit any exchange differences to be recycled on the classification of an asset or a disposal group as held for sale. The recycling will take place when the asset or disposal group is sold.

The allocation of an impairment loss to a disposal group

BC39 Under SFAS 144 and the proposals in ED 4, assets within the disposal group that are not within the scope of the IFRS are adjusted in accordance with other standards before measuring the fair value less costs to sell of the disposal group. Any loss or gain recognised on adjusting the carrying amount of the disposal group is allocated to the carrying amount of the long-lived assets of the group.

BC40 This is different from the requirements of IAS 36 for the allocation of an impairment loss arising on a cash-generating unit. IAS 36 requires an impairment loss on a cash-generating unit to be allocated first to reduce the carrying amount of goodwill and then to reduce pro rata the carrying amounts of the other assets in the unit.

BC41 The Board considered whether the allocation of an impairment loss for a disposal group should be consistent with the requirements of IAS 36 or with the requirements of SFAS 144. The Board concluded that it would be simplest to require the same allocation as is required by IAS 36 for cash-generating units. Although this is different from SFAS 144, the disposal group as a whole will be measured at the same amount.

Newly acquired assets

BC42 SFAS 144 requires, and ED 4 proposed, newly acquired assets that meet the criteria to be classified as held for sale to be measured at fair value less costs to sell on initial recognition. So, in those instances, other than in a business combination, in which an entity acquires a non-current asset that meets the criteria to be classified as held for sale, a loss is recognised in profit or loss if the cost of the asset exceeds its fair value less costs to sell. In the more common cases in which an entity acquires, as part of a business combination, a non-current asset (or disposal group) that meets the criteria to be classified as held for sale, the difference between fair value and fair value less costs to sell is recognised in goodwill.

BC43 Some respondents to ED 4 noted that measuring newly acquired assets not part of a business combination at fair value less costs to sell was inconsistent with the general proposal that assets classified as held for sale should be measured at *the lower of carrying amount* and fair value less costs to sell. The Board agreed and amended the requirement so that it is clear that the newly acquired assets (or disposal groups) are measured on initial recognition at the lower of what their carrying amount would be were they not classified as held for sale (ie cost) and fair value less costs to sell.

© Copyright

BC44 In relation to business combinations, the Board noted that conceptually the assets should be recognised initially at fair value and then immediately classified as held for sale, with the result that the costs to sell are recognised in profit or loss, not goodwill. In theory, if the entity had factored the costs to sell into the purchase price, the reduced price would lead to the creation of negative goodwill, the immediate recognition of which in profit or loss would offset the loss arising from the costs to sell. Of course, in practice, the reduced price will usually result in lower net positive goodwill rather than negative goodwill to be recognised in profit or loss. For that reason, and for the sake of convergence, the Board concluded that in a business combination non-current assets that meet the criteria to be classified as held for sale on acquisition should be measured at fair value less costs to sell on initial recognition.

BC45 The Board and the FASB are considering which items should form part of the business combination transaction more generally in their joint project on the application of the purchase method. This consideration includes whether the assets and liabilities recognised in the transaction should be based on the acquirer's or the acquiree's perspective. The outcome of those deliberations may affect the decision discussed in paragraph BC44.[*]

Recognition of subsequent increases in fair value less costs to sell

BC46 The Board considered whether a subsequent increase in fair value less costs to sell should be recognised to the extent that it reversed previous impairments. SFAS 144 requires the recognition of a subsequent increase in fair value less costs to sell, but not in excess of the cumulative loss previously recognised for a write-down to fair value less costs to sell. The Board decided that, under IFRSs, a gain should be recognised to the extent that it reverses any impairment of the asset, either in accordance with the IFRS or previously in accordance with IAS 36. Recognising a gain for the reversal of an impairment that occurred before the classification of the asset as held for sale is consistent with the requirement in IAS 36 to recognise reversals of impairment.

Recognition of impairment losses and subsequent gains for assets that, before classification as held for sale, were measured at revalued amounts in accordance with another IFRS

BC47 ED 4 proposed that impairment losses and subsequent gains for assets that, before classification as held for sale, were measured at revalued amounts in accordance with another IFRS should be treated as revaluation decreases and increases according to the standard under which the assets had previously been revalued, consistently with the requirements of IAS 36, except to the extent that the losses and gains are caused by the initial recognition of, or changes in, costs to sell. ED 4 also proposed that costs to sell should always be recognised in profit or loss.

[*] In their joint project on the application of the acquisition method, the Board and the FASB clarified that the classification of assets acquired in a business combination as held for sale should be based on the acquirer's perspective. Therefore, the acquirer would have to satisfy the criteria in paragraphs 6-11 of IFRS 5 at the acquisition date in order to classify assets acquired as held for sale on initial recognition.

© Copyright

BC48 Many respondents disagreed with these proposals, because of their complexity and because of the resulting inconsistent treatment of assets classified as held for sale. The Board considered the issues raised and decided that assets that were already carried at fair value with changes in fair value recognised in profit or loss should not be subject to the measurement requirements of the IFRS. The Board believes that, for such assets, continued measurement at fair value gives better information than measurement at the lower of carrying amount and fair value less costs to sell. The Board did not, however, believe that such treatment was appropriate for assets that had been revalued in accordance with IAS 16 and IAS 38, because those standards require depreciation to continue and the revaluation change would not necessarily be recognised in profit or loss. The Board concluded that assets that had been revalued in accordance with IAS 16 and IAS 38 should be treated in the same way as any assets that, before classification as held for sale, had not been revalued. Such an approach results in a consistent treatment for assets that are within the scope of the measurement requirements of the IFRS and, hence, a simpler standard.

Measurement of assets reclassified as held for use

BC49 Under SFAS 144, when an entity changes its plan to sell the asset and reclassifies a long-lived asset from held for sale to held and used, the asset is measured at the lower of (a) the carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation (or amortisation) that would have been recognised had the asset (or disposal group) been continuously classified as held and used and (b) its fair value at the date of the decision not to sell.

BC50 The underlying principle is to restore the carrying value of the asset to what it would have been had it never been classified as held for sale, taking into account any impairments that may have occurred. In fact, SFAS 144 requires that, for held and used assets, an impairment is recognised only if the carrying amount of the asset exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposal. Thus, the carrying amount of the asset if it had never been classified as held for sale might exceed its fair value. As a result, SFAS 144 does not necessarily lead to the asset reverting to its original carrying amount. However, the Basis for Conclusions on SFAS 144 notes that the FASB concluded it would be inappropriate to write up the carrying amount of the asset to an amount greater than its fair value solely on the basis of an undiscounted cash flow test. Hence, it arrived at the requirement for measurement at the lower of (a) the asset's carrying amount had it not been classified as held for sale and (b) fair value at the date of the decision not to sell the asset.

BC51 IAS 36 has a different measurement basis for impaired assets, ie recoverable amount. The Board concluded that to be consistent with the principle of SFAS 144 and also to be consistent with the requirements of IAS 36, an asset that ceases to be classified as held for sale should be measured at the lower of (a) the carrying amount that would have been recognised had the asset not been classified as held for sale and (b) its recoverable amount at the date of reclassification. Whilst this is not full convergence, the difference arises from differences in the US GAAP and IFRS impairment models.

Removal of exemption from consolidation for subsidiaries acquired and held exclusively with a view to resale

BC52 SFAS 144 removed the exemption from consolidation in US GAAP for subsidiaries held on a temporary basis on the grounds that all assets held for sale should be treated in the same way, ie as required by SFAS 144 rather than having some assets consolidated and some not.

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

* Greater disaggregation of the disposal group ~~on the face of~~in the ~~balance sheet~~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.

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.

© Copyright

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 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.

[*] 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.

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.

Presentation of discontinued operations

BC73 SFAS 144 requires the results of a discontinued operation to be presented as a separate component in the income statement (net of income tax) for all periods presented.

BC74 IAS 35 did not require the results of a discontinuing operation to be presented as a net amount on the face of the income statement. Instead, specified items are disclosed either in the notes or on the face of the income statement.

BC75 In ED 4, the Board noted that it was considering the presentation of discontinued operations in the income statement in its project on reporting comprehensive income and that it did not wish to prejudge the outcome of that project by changing the requirements of IAS 35 in respect of the components to be disclosed. Given that the project on reporting comprehensive income will not be completed as soon as previously expected, the Board decided to proceed with its decisions on the presentation of discontinued operations in this IFRS.

BC76 The Board believes that discontinued operations should be shown in a section of the income statement separately from continuing operations because of the different cash flows expected to arise from the two types of operations. The Board concluded that it is sufficient to show a single net figure for discontinued operations on the face of the income statement because of the limited future cash flows expected to arise from the operations. The IFRS therefore permits an analysis of the single net amount to be presented either in the notes or ~~on the face~~in ~~of~~ the income statement.[*]

BC77 A substantial majority of the respondents to ED 4 supported such a presentation.

BC77A The Board considered the comments received on the draft amendments in the 2007 exposure draft of proposed *Improvements to International Financial Reporting Standards*. Some respondents asked the Board to clarify the effects of the proposed amendment on the income statement when the disposal group meets the definition of a discontinued operation. The Board concluded that when a subsidiary is a disposal group that meets the definition of a discontinued operation in accordance with paragraph 32, an entity that is committed to a sale plan involving loss of control of the subsidiary should disclose the information required by paragraphs 33-36. The Board agreed with respondents that presentation should not differ simply because of the form of the disposal group.

[*] IAS *Presentation of Financial Statements* (as revised in 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).

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.

BC83 The Board considered using the phrase 'net selling price' to be consistent with IAS 36. However, it noted that 'fair value' is used in many IFRSs. The Board concluded that it would be preferable to use the same phrase as SFAS 144 so that it is clear that convergence on this point had been achieved and to amend IAS 36 so that the terminology in IAS 36 is consistent with other IFRSs. Therefore, a consequential amendment made by IFRS 5 replaces 'net selling price' with 'fair value less costs to sell' throughout IAS 36.

Summary of changes from ED 4

BC84 The major changes from the proposals in ED 4 are:

(a) clarification that assets classified as non-current are not reclassified as current until they meet the criteria to be classified as held for sale (paragraph BC10).

(b) goodwill and financial assets under leases are included in the scope of the measurement provisions of the IFRS (paragraphs BC8-BC14).

(c) non-current assets carried at fair value with changes recognised in profit or loss are excluded from the measurement provisions of the IFRS (paragraphs BC8-BC14).

(d) assets that are revalued in accordance with IAS 16 or IAS 38 are, when classified as held for sale, treated consistently with assets that had not previously been revalued (paragraphs BC47 and BC48).

(e) the allocation of an impairment loss on a disposal group is consistent with the order of allocation of impairment losses in IAS 36 (paragraphs BC39-BC41).

(f) the criterion in IAS 35 that a discontinued operation should be a major line of business or area of geographical operations has been added (paragraphs BC67-BC71).

(g) discontinued operations can be presented on the face of the income statement as a single amount (paragraphs BC73-BC77).

Comparison with relevant aspects of SFAS 144

BC85 The following table sets out the extent of convergence with SFAS 144:

Requirement	**Extent of convergence with SFAS 144**
Scope	Some differences in scope arising from other differences between IFRSs and US GAAP.
Criteria for classification as held for sale	Fully converged.
Treatment of assets to be exchanged	Fully converged if FASB proposals on exchanges of non-monetary assets are finalised.
Treatment of assets to be abandoned	Fully converged.

Measurement on initial classification	Converged, other than cumulative exchange differences recognised directly in equity* that are included in the carrying amount of the asset (or disposal group) under US GAAP but are not under IFRS 5.
Subsequent measurement	Converged on the principles, but some differences arising from different requirements on reversals of previous impairments.
Changes to a plan to sell	Converged on reclassification and on measurement, except for differences arising from different requirements on reversals of previous impairments.
Presentation of assets classified as held for sale	Fully converged.
Definition of a discontinued operation	Not converged but the Board intends to work with the FASB to arrive at a converged definition within a relatively short time.
Timing of classification of an operation as discontinued	Fully converged.
Presentation of a discontinued operation	Converged except that SFAS 144 requires the presentation of pre- and post-tax profits on the face of the income statement and IFRS 5 requires the presentation of post-tax profit only (although disaggregation is permitted).

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* (as revised in 2007) such differences are recognised in other comprehensive income.

Dissenting opinions on IFRS 5

Dissent of Anthony T Cope and Harry K Schmid

DO1 Messrs Cope and Schmid dissent from the issue of IFRS 5.

Dissent of Anthony T Cope

DO2 Mr Cope dissents because, in his view, the IFRS fails to meet fully the needs of users in this important area.

DO3 In deciding to undertake this project, the Board had two objectives—to improve users' ability to assess the amount, timing and uncertainty of future cash flows, and to converge with US GAAP. The ability to identify assets (or asset groups) whose value will be recovered principally through sale rather than through operations has significant implications for future cash flows. Similarly, separate presentation of discontinued operations enables users to distinguish those parts of a business that will not contribute to future cash flows.

DO4 The importance of identifying and disaggregating these components was emphasised in the 1994 report of the Special Committee on Financial Reporting of the American Institute of Certified Public Accountants (the AICPA Jenkins Committee). The Jenkins Committee report, arguably the most extensive and authoritative survey of user needs ever undertaken, recommended that:

> [The definition of discontinued operations] should be broadened to include all significant discontinued operations whose assets and results of operations and activities can be distinguished physically and operationally and for business reporting purposes.

The sections of SFAS 144 dealing with discontinued operations were the direct response of the FASB to this recommendation.

DO5 Indeed, the Board appeared to agree in its initial deliberations. In ED 4, the Board stated:

> [The Board] further concluded that the definition of discontinued operations in SFAS 144 leads to more useful information being presented and disclosed for a wider range of operations than did the existing definition in IAS 35. That information is important to users in their assessment of the amount, timing and uncertainty of future cash flows.

Mr Cope continues to agree with that statement.

DO6. However, the Board ultimately has decided to retain the definition in IAS 35, thus failing to gain convergence on an important point in a project designed to achieve such convergence, and failing to respond to the stated needs of users.

DO7 The reason given for the Board's action is that implementation problems with SFAS 144 have emerged in the US. (Most of these problems seem to be with the guidance concerning the definition in SFAS 144, rather than the definition itself.) In paragraph BC71, the Board describes its action as an interim measure, and plans to work with the FASB to arrive promptly at a converged solution. In Mr Cope's view, it would have been much preferable to have converged first, and then dealt with any

implementation problems jointly with the FASB.

Dissent of Harry K Schmid

DO8 The main reasons for Mr Schmid's dissent are:

(a) depreciation/amortisation of non-current assets that are still in active use should not cease only because of a management decision to sell the assets that has not yet been fully carried out; and

(b) measurement of assets should not be based on a management decision that has not yet been fully carried out, requiring a very rule-based Standard.

DO9 Mr Schmid believes that not depreciating/amortising assets classified as held for sale but still in active use is conceptually wrong and is especially problematic for discontinued operations because such operations represent a separate major line of business or geographical area of operations. Mr Schmid does not accept that measurement at the lower of carrying amount and fair value less costs to sell acts as a proxy for depreciation because, in most such cases, the fair value less costs to sell will be higher than the carrying amount as the fair value of such disposal groups will often reflect internally generated goodwill. Therefore, non-current assets in such disposal groups will simply remain at their carrying amounts even though they are still actively used, up to one year or even longer. In addition, the net profit shown separately in the income statement for discontinued operations will not be meaningful because depreciation/amortisation charges are not deducted for the continued use of the assets and this profit cannot be compared with the information restated in comparative periods where depreciation had been charged.

DO10 The proposed classification 'held for sale' and resulting measurement of non-current assets (or disposal groups) so classified is based on a management decision that has not yet been fully carried out and demands detailed (anti-abuse) rules to define the classification and to fix the time boundaries during which these assets can remain within the classification. The final result is, in Mr Schmid's view, an excessively detailed and rule-based Standard.

DO11 Mr Schmid believes that a more simple and straightforward solution would have been possible by creating a special category of non-current assets retired from active use. The concept 'retired from active use' would have been simple to apply and management intentions would be removed from the Standard. The classification would equally apply to any form of disposal (sale, abandonment, exchange, spin-off etc); no detailed (anti-abuse) rules and no illustrations would be necessary and the Standard would be simple and based on a clear and unambiguous principle. Mr Schmid, on this point, does not agree with the conclusions in paragraph BC18 that a classification 'retired from active use' would not require fewer criteria to support it than the category 'assets held for sale'.

DO12 Mr Schmid agrees with paragraph BC17 of the Basis for Conclusions, but in order to provide information of intended sales of non-current assets, especially discontinued operations, disclosure could have been required to take effect as soon as such assets are likely to be sold, even if they are still in active use.

DO13 Mr Schmid is fully in favour of seeking, whenever possible, convergence with US GAAP, but only if the converged solution is of high quality. He is of the opinion that this is not the case for this Standard for the reasons given.

Appendix
Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs 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. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) — effective for annual periods beginning on or after 1 January 2013

In paragraph BC8(b) the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

> * In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

In paragraph BC13 the footnote to 'IAS 39' is deleted and replaced by the following footnote:

> * In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

In paragraph BC54(b) the reference to 'IAS 39' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of held-for-trading financial assets. Paragraph BC54 discusses matters relevant when IFRS 5 was issued.

In paragraph BC58 the reference to 'available-for-sale' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets. Paragraph BC58 discusses matters relevant when IFRS 5 was issued.

© Copyright

HKFRS 5 IG
~~Issued August 2004~~ Revised February 2010

Guidance on Implementing
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

CONTENTS

Guidance on Implementing IFRS 5 *NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS*

Availability for immediate sale (paragraph 7)	**Examples 1–3**
Completion of sale expected within one year (paragraph 8)	**Example 4**
Exceptions to the criterion that the sale should be expected to be completed in one year (paragraphs 8 and B1)	**Examples 5-7**
Determining whether an asset has been abandoned (paragraphs 13 and 14)	**Example 8**
Presenting a discontinued operation that has been abandoned (paragraph 13)	**Example 9**
Allocation of an impairment loss on a disposal group (paragraph 23)	**Example 10**
Presenting discontinued operations in the ~~income statement~~statement of comprehensive income (paragraph 38)	**Example 11**
Presenting non-current assets or disposal groups classified as held for sale (paragraph 38)	**Example 12**
Measuring and presenting subsidiaries acquired with a view to resale and classified as held for sale (paragraphs 11 and 38)	**Example 13**
Guidance on the effect of IFRS 5 on IAS 36 and~~,~~ IAS 38 ~~and IFRS 3~~	

© Copyright

Guidance on implementing IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

This guidance accompanies, but is not part of, IFRS 5.

Availability for immediate sale (paragraph 7)

To qualify for classification as held for sale, a non-current asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) (paragraph 7). A non-current asset (or disposal group) is available for immediate sale if an entity currently has the intention and ability to transfer the asset (or disposal group) to a buyer in its present condition. Examples 1-3 illustrate situations in which the criterion in paragraph 7 would or would not be met.

Example 1

An entity is committed to a plan to sell its headquarters building and has initiated actions to locate a buyer.

(a) The entity intends to transfer the building to a buyer after it vacates the building. The time necessary to vacate the building is usual and customary for sales of such assets. The criterion in paragraph 7 would be met at the plan commitment date.

(b) The entity will continue to use the building until construction of a new headquarters building is completed. The entity does not intend to transfer the existing building to a buyer until after construction of the new building is completed (and it vacates the existing building). The delay in the timing of the transfer of the existing building imposed by the entity (seller) demonstrates that the building is not available for immediate sale. The criterion in paragraph 7 would not be met until construction of the new building is completed, even if a firm purchase commitment for the future transfer of the existing building is obtained earlier.

Example 2

An entity is committed to a plan to sell a manufacturing facility and has initiated actions to locate a buyer. At the plan commitment date, there is a backlog of uncompleted customer orders.

(a) The entity intends to sell the manufacturing facility with its operations. Any uncompleted customer orders at the sale date will be transferred to the buyer. The transfer of uncompleted customer orders at the sale date will not affect the timing of the transfer of the facility. The criterion in paragraph 7 would be met at the plan commitment date.

(b) The entity intends to sell the manufacturing facility, but without its operations. The entity does not intend to transfer the facility to a buyer until after it ceases all operations of the facility and eliminates the backlog of uncompleted customer orders. The delay in the timing of the transfer of the facility imposed by the entity (seller) demonstrates that the facility is not available for immediate sale. The criterion in paragraph 7 would not be met until the operations of the facility cease, even if a firm purchase commitment for the future transfer of the facility were obtained earlier.

© Copyright

Example 3

An entity acquires through foreclosure a property comprising land and buildings that it intends to sell.

(a) The entity does not intend to transfer the property to a buyer until after it completes renovations to increase the property's sales value. The delay in the timing of the transfer of the property imposed by the entity (seller) demonstrates that the property is not available for immediate sale. The criterion in paragraph 7 would not be met until the renovations are completed.

(b) After the renovations are completed and the property is classified as held for sale but before a firm purchase commitment is obtained, the entity becomes aware of environmental damage requiring remediation. The entity still intends to sell the property. However, the entity does not have the ability to transfer the property to a buyer until after the remediation is completed. The delay in the timing of the transfer of the property imposed by others before a firm purchase commitment is obtained demonstrates that the property is not available for immediate sale. The criterion in paragraph 7 would not continue to be met. The property would be reclassified as held and used in accordance with paragraph 26.

Completion of sale expected within one year (paragraph 8)

Example 4

To qualify for classification as held for sale, the sale of a non-current asset (or disposal group) must be highly probable (paragraph 7), and transfer of the asset (or disposal group) must be expected to qualify for recognition as a completed sale within one year (paragraph 8). That criterion would not be met if, for example:

(a) an entity that is a commercial leasing and finance company is holding for sale or lease equipment that has recently ceased to be leased and the ultimate form of a future transaction (sale or lease) has not yet been determined.

(b) an entity is committed to a plan to 'sell' a property that is in use, and the transfer of the property will be accounted for as a sale and finance leaseback.

Exceptions to the criterion in paragraph 8

An exception to the one-year requirement in paragraph 8 applies in limited situations in which the period required to complete the sale of a non-current asset (or disposal group) will be (or has been) extended by events or circumstances beyond an entity's control and specified conditions are met (paragraphs 9 and B1). Examples 5-7 illustrate those situations.

Example 5

An entity in the power generating industry is committed to a plan to sell a disposal group that represents a significant portion of its regulated operations. The sale requires regulatory approval, which could extend the period required to complete the sale beyond one year. Actions necessary to obtain that approval cannot be initiated until after a buyer is known and a firm purchase commitment is obtained. However, a firm purchase commitment is highly probable within one year. In that situation, the conditions in paragraph B1(a) for an exception to the one-year requirement in paragraph 8 would be met.

© Copyright

Example 6

An entity is committed to a plan to sell a manufacturing facility in its present condition and classifies the facility as held for sale at that date. After a firm purchase commitment is obtained, the buyer's inspection of the property identifies environmental damage not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the period required to complete the sale beyond one year. However, the entity has initiated actions to make good the damage, and satisfactory rectification of the damage is highly probable. In that situation, the conditions in paragraph B1(b) for an exception to the one-year requirement in paragraph 8 would be met.

Example 7

An entity is committed to a plan to sell a non-current asset and classifies the asset as held for sale at that date.

(a) During the initial one-year period, the market conditions that existed at the date the asset was classified initially as held for sale deteriorate and, as a result, the asset is not sold by the end of that period. During that period, the entity actively solicited but did not receive any reasonable offers to purchase the asset and, in response, reduced the price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions, and the criteria in paragraphs 7 and 8 are therefore met. In that situation, the conditions in paragraph B1(c) for an exception to the one-year requirement in paragraph 8 would be met. At the end of the initial one-year period, the asset would continue to be classified as held for sale.

(b) During the following one-year period, market conditions deteriorate further, and the asset is not sold by the end of that period. The entity believes that the market conditions will improve and has not further reduced the price of the asset. The asset continues to be held for sale, but at a price in excess of its current fair value. In that situation, the absence of a price reduction demonstrates that the asset is not available for immediate sale as required by paragraph 7. In addition, paragraph 8 also requires an asset to be marketed at a price that is reasonable in relation to its current fair value. Therefore, the conditions in paragraph B1(c) for an exception to the one-year requirement in paragraph 8 would not be met. The asset would be reclassified as held and used in accordance with paragraph 26.

Determining whether an asset has been abandoned

Paragraphs 13 and 14 of the IFRS specify requirements for when assets are to be treated as abandoned. Example 8 illustrates when an asset has not been abandoned.

Example 8

An entity ceases to use a manufacturing plant because demand for its product has declined. However, the plant is maintained in workable condition and it is expected that it will be brought back into use if demand picks up. The plant is not regarded as abandoned.

Presenting a discontinued operation that has been abandoned

Paragraph 13 of the IFRS prohibits assets that will be abandoned from being classified as held for sale. However, if the assets to be abandoned are a major line of business or geographical area of operations, they are reported in discontinued operations at the date at which they are abandoned. Example 9 illustrates this.

© Copyright

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 ~~date~~ 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	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 estimates that fair value less costs to sell of the disposal group amounts to 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. 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).

© Copyright

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
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 ~~on the face of the income statement~~in the statement of comprehensive income for discontinued operations with an analysis in the notes or in a section of the ~~income~~ statement of comprehensive income separate from continuing operations. Example 11 illustrates how these requirements might be met.

Example 11

XYZ GROUP - ~~INCOME~~ STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2 (illustrating the classification of expenses by function)*

(in thousands of currency units)

Continuing operations	**20X2**	**20X1**
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period from continuing operations	X	X
Discontinued operations		
Profit for the period from discontinued operations[(a)]	X	X
Profit for the period	X	X
Attributable to:		
Owners of the parent	~~X~~	~~X~~
Profit for the period from continuing operations	X	X
Profit for the period from discontinued operations	X	X
Profit for the period attributable to owners of the parent	X	X
~~Minority interest~~Non-controlling interests*	~~X~~	~~X~~
Profit for the period from continuing operations	X	X
Profit for the period from discontinued operations	X	X
Profit for the period attributable to non-controlling interests	X	X
	X	X

(a) The required analysis would be given in the notes.

(b) The entity did not recognise any components of other comprehensive income in the periods presented.

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

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 ~~balance sheet~~ statement of financial position. The liabilities of a disposal group classified as held for sale are also presented separately from other liabilities in the ~~balance sheet~~ 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	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 ~~directly in equity~~in other comprehensive income and accumulated in equity.

The presentation in the entity's ~~balance sheet~~statement of financial position of the disposal groups classified as held for sale can be shown as follows:

	20X5	**20X4**
ASSETS		
Non-current assets		
AAA	X	X
BBB	X	X
CCC	X	X
	X	X
Current assets		
DDD	X	X
EEE	X	X
	X	X
Non-current assets classified as held for sale	8,000	-
	X	X
Total assets	X	X
	20X5	**20X4**
EQUITY AND LIABILITIES		
Equity attributable to ~~equity holders~~owners of the parent		
FFF	X	X
GGG	X	X
Amounts recognised ~~directly~~ in ~~equity~~ other comprehensive income and accumulated in equity relating to non-current assets held for sale	400	-
	X	X
~~Minority interest~~Non-controlling interests*	X	X
Total equity	X	X
Non-current liabilities		
HHH	X	X
III	X	X
JJJ	X	X
	X	X

continued …

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

… continued

Current liabilities		
KKK	X	X
LLL	X	X
MMM	X	X
Liabilities directly associated with non-current assets classified as held for sale	3,300	-
	X	X
Total liabilities	X	X
Total equity and liabilities	X	X

The presentation requirements for assets (or disposal groups) classified as held for sale at the end of the reporting period do not apply retrospectively. The comparative ~~balance sheets~~ statement of financial position for any previous periods are therefore not re-presented.

Measuring and presenting subsidiaries acquired with a view to resale and classified as held for sale

A subsidiary acquired with a view to sale is not exempt from consolidation in accordance with IAS 27 *Consolidated and Separate Financial Statements*. However, if it meets the criteria in paragraph 11, it is presented as a disposal group classified as held for sale. Example 13 illustrates these requirements.

Example 13

Entity A acquires an entity H, which is a holding company with two subsidiaries, S1 and S2. S2 is acquired exclusively with a view to sale and meets the criteria to be classified as held for sale. In accordance with paragraph 32(c), S2 is also a discontinued operation.

The estimated fair value less costs to sell of S2 is CU135. A accounts for S2 as follows:

- initially, A measures the identifiable liabilities of S2 at fair value, say at CU40
- initially, A measures the acquired assets as the fair value less costs to sell of S2 (CU135) plus the fair value of the identifiable liabilities (CU40), ie at CU175
- at the ~~balance sheet date~~end of the reporting period, A remeasures the disposal group at the lower of its cost and fair value less costs to sell, say at CU130. The liabilities are remeasured in accordance with applicable IFRSs, say at CU35. The total assets are measured at CU130+CU35, ie at CU165
- at the ~~balance sheet date~~end of the reporting period, A presents the assets and

© Copyright

liabilities separately from other assets and liabilities in its consolidated financial statements as illustrated in Example 12 *Presenting non-current assets or disposal groups classified as held for sale*, and

- in the ~~income statement~~statement of comprehensive income, A presents the total of the post-tax profit or loss of S2 and the post-tax gain or loss recognised on the subsequent remeasurement of S2, which equals the remeasurement of the disposal group from CU135 to CU130.

Further analysis of the assets and liabilities or of the change in value of the disposal group is not required.

© Copyright

HKFRS 6
Revised ~~December 2008~~February 2010

Effective for annual periods
beginning on or after 1 January 2006

Hong Kong Financial Reporting Standard 6

Exploration for and Evaluation of Mineral Resources

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

COPYRIGHT

© Copyright 2008 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains International Accounting Standards Committee Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Operation and Finance, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by International Accounting Standards Committee Foundation. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

CONTENTS

	paragraphs
INTRODUCTION	**IN1-IN5**

HONG KONG FINANCIAL REPORTING STANDARD 6
EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES

OBJECTIVE	**1-2**
SCOPE	**3-5**
RECOGNITION OF EXPLORATION AND EVALUATION ASSETS	**6-7**
Temporary exemption from HKAS 8 paragraphs 11 and 12	**6-7**
MEASUREMENT OF EXPLORATION AND EVALUATION ASSETS	**8-14**
Measurement at recognition	**8**
Elements of cost of exploration and evaluation assets	**9-11**
Measurement after recognition	**12**
Changes in accounting policies	**13-14**
PRESENTATION	**15-17**
Classification of exploration and evaluation assets	**15-16**
Reclassification of exploration and evaluation assets	**17**
IMPAIRMENT	**18-22**
Recognition and measurement	**18-20**
Specifying the level at which exploration and evaluation assets are assessed for impairment	**21-22**
DISCLOSURE	**23-25**
EFFECTIVE DATE	**26**
TRANSITIONAL PROVISIONS	**27**

APPENDICES

A **Defined terms**

B **Amendments to other HKFRSs**

C **Comparison with International Financial Reporting Standards**

BASIS FOR CONCLUSIONS

DISSENTING OPINIONS

Hong Kong Financial Reporting Standard 6 *Exploration for and Evaluation of Mineral Resources* (HKFRS 6) is set out in paragraphs 1-27 and Appendices A and B. 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 6 should be read in the context of its objective and the Basis for Conclusions, 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.

Introduction

Reasons for issuing the HKFRS

IN1 The Hong Kong Institute of Certified Public Accountants (HKICPA) decided to adopt International Financial Reporting Standard 6 *Exploration for and Evaluation of Mineral Resources* issued by the International Accounting Standards Board (the Board) as a Hong Kong Financial Reporting Standard (HKFRS) on exploration for and evaluation of mineral resources in the light of its convergence policy. The HKICPA noted and agreed with the following reasons of the Board to develop IFRS 6 because:

(a) until now there has been no IFRS that specifically addresses the accounting for those activities and they are excluded from the scope of IAS 38 *Intangible Assets*. In addition, 'mineral rights and mineral resources such as oil, natural gas and similar non-regenerative resources' are excluded from the scope of IAS 16 *Property, Plant and Equipment*. Consequently, an entity was required to determine its accounting policy for the exploration for and evaluation of mineral resources in accordance with paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(b) there are different views on how exploration and evaluation expenditures should be accounted for in accordance with IFRSs.

(c) accounting practices for exploration and evaluation assets under the requirements of other standard-setting bodies are diverse and often differ from practices in other sectors for expenditures that may be considered analogous (eg accounting practices for research and development costs in accordance with IAS 38).

(d) exploration and evaluation expenditures are significant to entities engaged in extractive activities.

(e) an increasing number of entities incurring exploration and evaluation expenditures present their financial statements in accordance with IFRSs, and many more are expected to do so from 2005.

IN2 The Board's predecessor organisation, the International Accounting Standards Committee, established a Steering Committee in 1998 to carry out initial work on accounting and financial reporting by entities engaged in extractive activities. In November 2000 the Steering Committee published an Issues Paper *Extractive Industries*.

IN3 In July 2001 the Board announced that it would restart the project only when agenda time permitted. Although the Board recognised the importance of accounting for extractive activities generally, it decided in September 2002 that it was not feasible to complete the detailed analysis required for this project, obtain appropriate input from constituents and undertake the Board's normal due process in time to implement changes before many entities adopted IFRSs in 2005.

IN4 The Board's objectives for this phase of its extractive activities project are:

(a) to make limited improvements to accounting practices for exploration and evaluation expenditures, without requiring major changes that might be reversed when the Board undertakes a comprehensive review of accounting practices used by entities engaged in the exploration for and evaluation of mineral resources.

(b) to specify the circumstances in which entities that recognise exploration and evaluation assets should test such assets for impairment in accordance with IAS 36 *Impairment of Assets*.

(c) to require entities engaged in the exploration for and evaluation of mineral resources to disclose information about exploration and evaluation assets, the level at which such assets are assessed for impairment and any impairment losses recognised.

Main features of the HKFRS

IN5 The HKFRS:

(a) permits an entity to develop an accounting policy for exploration and evaluation assets without specifically considering the requirements of paragraphs 11 and 12 of HKAS 8. Thus, an entity adopting HKFRS 6 may continue to use the accounting policies applied immediately before adopting the HKFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

(b) requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount.

(c) varies the recognition of impairment from that in HKAS 36 but measures the impairment in accordance with that Standard once the impairment is identified.

Hong Kong Financial Reporting Standard 6
Exploration for and Evaluation of Mineral Resources

Objective

1 The objective of this HKFRS is to specify the financial reporting for the *exploration for and evaluation of mineral resources.*

2 In particular, the HKFRS requires:

(a) limited improvements to existing accounting practices for *exploration and evaluation expenditures.*

(b) entities that recognise *exploration and evaluation assets* to assess such assets for impairment in accordance with this HKFRS and measure any impairment in accordance with HKAS 36 *Impairment of Assets*.

(c) disclosures that identify and explain the amounts in the entity's financial statements arising from the exploration for and evaluation of mineral resources and help users of those financial statements understand the amount, timing and certainty of future cash flows from any exploration and evaluation assets recognised.

Scope

3 An entity shall apply the HKFRS to exploration and evaluation expenditures that it incurs.

4 The HKFRS does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral resources.

5 An entity shall not apply the HKFRS to expenditures incurred:

(a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.

(b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Recognition of exploration and evaluation assets

Temporary exemption from HKAS 8 paragraphs 11 and 12

6 When developing its accounting policies, an entity recognising exploration and evaluation assets shall apply paragraph 10 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

7 Paragraphs 11 and 12 of HKAS 8 specify sources of authoritative requirements and guidance that management is required to consider in developing an accounting policy for an item if no HKFRS applies specifically to that item. Subject to paragraphs 9 and 10 below, this HKFRS exempts an entity from applying those paragraphs to its accounting policies for the recognition and measurement of exploration and evaluation assets.

Measurement of exploration and evaluation assets

Measurement at recognition

8 Exploration and evaluation assets shall be measured at cost.

Elements of cost of exploration and evaluation assets

9 An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

(a) acquisition of rights to explore;

(b) topographical, geological, geochemical and geophysical studies;

(c) exploratory drilling;

(d) trenching;

(e) sampling; and

(f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

10 Expenditures related to the development of mineral resources shall not be recognised as exploration and evaluation assets. The *Framework* and HKAS 38 *Intangible Assets* provide guidance on the recognition of assets arising from development.

11 In accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources.

Measurement after recognition

12 After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets. If the revaluation model is applied (either the model in HKAS 16 *Property, Plant and Equipment* or the model in HKAS 38) it shall be consistent with the classification of the assets (see paragraph 15).

Changes in accounting policies

13 An entity may change its accounting policies for exploration and evaluation expenditures 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 entity shall judge relevance and reliability using the criteria in HKAS 8.

14 To justify changing its accounting policies for exploration and evaluation expenditures, an entity shall demonstrate 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.

Presentation

Classification of exploration and evaluation assets

15 An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.

16 Some exploration and evaluation assets are treated as intangible (eg drilling rights), whereas others are tangible (eg vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.

Reclassification of exploration and evaluation assets

17 An exploration and evaluation asset shall no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Exploration and evaluation assets shall be assessed for impairment, and any impairment loss recognised, before reclassification.

Impairment

Recognition and measurement

18 Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. When facts and circumstances suggest that the carrying amount exceeds the recoverable amount, an entity shall measure, present and disclose any resulting impairment loss in accordance with HKAS 36, except as provided by paragraph 21 below.

19 For the purposes of exploration and evaluation assets only, paragraph 20 of this HKFRS shall be applied rather than paragraphs 8-17 of HKAS 36 when identifying an exploration and evaluation asset that may be impaired. Paragraph 20 uses the term 'assets' but applies equally to separate exploration and evaluation assets or a cash-generating unit.

20 One or more of the following facts and circumstances indicate that an entity should test exploration and evaluation assets for impairment (the list is not exhaustive):

(a) the period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.

(b) substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.

(c) exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.

(d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

In any such case, or similar cases, the entity shall perform an impairment test in accordance with HKAS 36. Any impairment loss is recognised as an expense in accordance with HKAS 36.

Specifying the level at which exploration and evaluation assets are assessed for impairment

21 **An entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. Each cash-generating unit or group of units to which an exploration and evaluation asset is allocated shall not be larger than ~~a segment based on either the entity's primary or secondary reporting format~~ an operating segment determined in accordance with ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments*.**

22 The level identified by the entity for the purposes of testing exploration and evaluation assets for impairment may comprise one or more cash-generating units.

Disclosure

23 **An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.**

24 To comply with paragraph 23, an entity shall disclose:

(a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

(b) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

25 An entity shall treat exploration and evaluation assets as a separate class of assets and make the disclosures required by either HKAS 16 or HKAS 38 consistent with how the assets are classified.

Effective date

26 **An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies the HKFRS for a period beginning before 1 January 2006, it shall disclose that fact.**

Transitional provisions

27 If it is impracticable to apply a particular requirement of paragraph 18 to comparative information that relates to annual periods beginning before 1 January 2006, an entity shall disclose that fact. HKAS 8 explains the term 'impracticable'.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

exploration and evaluation assets	**Exploration and evaluation expenditures** recognised as assets in accordance with the entity's accounting policy.
exploration and evaluation expenditures	Expenditures incurred by an entity in connection with the **exploration for and evaluation of mineral resources** before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.
exploration for and evaluation of mineral resources	The search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

Appendix B
Amendments to other HKFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies this HKFRS for an earlier period, these amendments shall be applied for that earlier period. In the amendments, new text is underlined and deleted text is struck through.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix C
Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared as at February 2005 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 6.

The International Financial Reporting Standard comparable with HKFRS 6 is IFRS 6 *Exploration for and Evaluation of Mineral Resources.*

There are no major textual differences between HKFRS 6 and IFRS 6.

HKFRS 6 is based on IFRS 6 *Exploration for and Evaluation of Mineral Resources*. In approving HKFRS 6, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 6. Accordingly, there are no significant differences between HKFRS 6 and IFRS 6. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 6 referred to below generally correspond with those in HKFRS 6.

Contents

BASIS FOR CONCLUSIONS ON IFRS 6 *EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES*

	paragraphs
INTRODUCTION	**BC1**
REASONS FOR ISSUING THE IFRS	**BC2-BC5**
SCOPE	**BC6-BC8**
DEFINITION OF EXPLORATION AND EVALUATION ASSETS	**BC9-BC16**
Expenditures incurred before the exploration for and evaluation of mineral resources	**BC10-BC13**
Separate definitions of 'exploration' and 'evaluation'	**BC14-BC15**
Mineral resources	**BC16**
RECOGNITION OF EXPLORATION AND EVALUATION ASSETS	**BC17-BC31**
Temporary exemption from IAS 8 paragraphs 11 and 12	**BC17-BC23**
Elements of cost of exploration and evaluation assets	**BC24-BC28**
Measurement after recognition	**BC29-BC31**
PRESENTATION OF EXPLORATION AND EVALUATION ASSETS	**BC32-BC34**
IMPAIRMENT OF EXPLORATION AND EVALUATION ASSETS	**BC35-BC48**
Assessment of impairment	**BC36-BC39**
The level at which impairment is assessed	**BC40-BC47**
Reversal of impairment losses	**BC48**
CHANGES IN ACCOUNTING POLICIES	**BC49**
DISCLOSURES	**BC50-BC57**
Commercial reserves	BC55
Stages after exploration and evaluation	BC56
Project timing	BC57
EFFECTIVE DATE	**BC58**
TRANSITION	**BC59-BC65**
SUMMARY OF CHANGES FROM ED 6	**BC66**
DISSENTING OPINIONS	

Basis for Conclusions on IFRS 6 *Exploration for and Evaluation of Mineral Resources*

This Basis for Conclusions accompanies, but is not part of, IFRS 6.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 6 *Exploration for and Evaluation of Mineral Resources.* Individual Board members gave greater weight to some factors than to others.

Reasons for issuing the IFRS

BC2 Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Without the exemption in IFRS 6, an entity adopting IFRSs in 2005 would have needed to assess whether its accounting policies for the exploration for and evaluation of mineral resources complied with those 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 entities might have made major changes in 2005 followed by further significant changes once the Board completes its comprehensive review of accounting for extractive activities.

BC3 To avoid unnecessary disruption for both users and preparers at this time, the Board proposed to limit the need for entities to change their existing accounting policies for exploration and evaluation assets. The Board did this by:

(a) creating a temporary exemption from parts of the hierarchy in IAS 8 that specify the criteria an entity uses in developing an accounting policy if no IFRS applies specifically.

(b) limiting the impact of that exemption from the hierarchy by identifying expenditures to be included in and excluded from exploration and evaluation assets and requiring all exploration and evaluation assets to be assessed for impairment.

BC4 The Board published its proposals in January 2004. ED 6 *Exploration for and Evaluation of Mineral Resources* had a comment deadline of 16 April 2004. The Board received 55 comment letters.

BC5 In April 2004 the Board approved a research project to be undertaken by staff from the national standard-setters in Australia, Canada, Norway and South Africa that will address accounting for extractive activities generally. The research project team is assisted by an advisory panel, which includes members from industry (oil and gas and mining sectors), accounting firms, users and securities regulators from around the world.

Scope

BC6 In the Board's view, even though no IFRS has addressed extractive activities directly, all IFRSs (including International Accounting Standards and Interpretations) are applicable to entities engaged in the exploration for and evaluation of mineral resources that make an unreserved statement of compliance with IFRSs in accordance with IAS 1 *Presentation of Financial Statements*. Consequently, each IFRS must be applied by all such entities.

BC7 Some respondents to ED 6 encouraged the Board to develop standards for other stages in the process of exploring for and evaluating mineral resources, including pre-exploration activities (ie activities preceding the exploration for and evaluation of mineral resources) and development activities (ie activities after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable). The Board decided not to do this for two reasons. First, it did not want to prejudge the comprehensive review of the accounting for such activities. Second, the Board concluded that an appropriate accounting policy for pre-exploration activities could be developed from an application of existing IFRSs, from the *Framework*'s definitions of assets and expenses, and by applying the general principles of asset recognition in IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

BC8 The Board also decided not to expand the scope of IFRS 6 beyond that proposed in ED 6 because to do so would require additional due process, possibly including another exposure draft. In view of the many entities engaged in extractive activities that would be required to apply IFRSs from 1 January 2005, the Board decided that it should not delay issuing guidance by expanding the scope of the IFRS beyond the exploration for and evaluation of mineral resources.

Definition of exploration and evaluation assets

BC9 Most respondents to ED 6 agreed with the Board's proposed definition of exploration and evaluation assets, but asked for changes or clarifications to make the Board's intentions clearer:

(a) some respondents asked the Board to distinguish between exploration and pre-exploration expenditures.

(b) others asked the Board to define exploration and evaluation activities separately, reflecting the different risk profiles of such activities or the requirements of other jurisdictions.

(c) other respondents asked for further guidance on what constitute mineral resources, principally examples of what constitutes a mineral reserve.

Expenditures incurred before the exploration for and evaluation of mineral resources

BC10 Respondents seemed ~~either~~ to be concerned that the Board was extending the scope of the proposals to include expenditures incurred before the acquisition of legal rights to explore in a specific area in the definition of exploration and evaluation expenditure. Some were concerned that such an extension would open the way for the recognition of such expenditures as assets; others preferred this result. In drafting IFRS 6, the Board could not identify any reason why the *Framework* was not applicable to such expenditures.

BC11 The Board decided not to define pre-acquisition or pre-exploration expenditures. However, the IFRS clarifies that expenditures before the entity has obtained legal rights to explore in a specific area are not exploration and evaluation expenditures and are therefore outside the scope of the IFRS.

BC12 The Board noted that an appropriate application of IFRSs might require pre-acquisition expenditures related to the acquisition of an intangible asset (eg expenditures directly attributable to the acquisition of an exploration licence) to be recognised as part of the intangible asset in accordance with IAS 38. Paragraph 27(a) of IAS 38 states that the cost of a separately acquired intangible asset comprises its purchase price, including import duties and non-refundable purchase taxes, and some directly attributable costs.

BC13 Similarly, the Board understands that expenditures incurred before the exploration for and evaluation of mineral resources cannot usually be associated with any specific mineral property and thus are likely to be recognised as an expense as incurred. However, such expenditures need to be distinguished from expenditures on infrastructure—for example access roads—necessary for the exploration work to proceed. Such expenditures should be recognised as property, plant and equipment in accordance with paragraph 3 of IAS 16.

Separate definitions of 'exploration' and 'evaluation'

BC14 Some respondents asked the Board to provide separate definitions of exploration and evaluation. The Board considered using the definitions provided in the Issues Paper *Extractive Industries* published by its predecessor, the Board of the International Accounting Standards Committee, in November 2000, because those definitions would be acceptable to many respondents, particularly because they are based on definitions that have been used for a number of years in both the mining and the oil and gas sectors.

BC15 The Board concluded that distinguishing between evaluation and exploration would not improve the IFRS. Exploration and evaluation are accounted for in the same way.

Mineral resources

BC16 Some respondents asked the Board to define mineral resources more precisely. The Board concluded that, for the purposes of the IFRS, elaboration was unnecessary. The items listed in the definition of exploration for and evaluation of mineral resources were sufficient to convey the Board's intentions.

Recognition of exploration and evaluation assets

Temporary exemption from IAS 8 paragraphs 11 and 12

BC17 A variety of accounting practices are followed by entities engaged in the exploration for and evaluation of mineral resources. These practices range from deferring on the balance sheet nearly all exploration and evaluation expenditure to recognising all such expenditure in profit or loss as incurred. The IFRS permits these various accounting practices to continue. Given this diversity, some respondents to ED 6 opposed any exemption from paragraphs 11 and 12 of IAS 8. These respondents were concerned that entities could give the appearance of compliance with IFRSs while being inconsistent with the stated objectives of the IASB, ie to provide users of financial statements with financial information that was of high quality, transparent and comparable. The Board did not grant the exemption from parts of IAS 8 lightly, but took this step to minimise disruption, especially in 2006 (or 2005, for those entities that adopt the IFRS early), both for users (eg lack of continuity of trend data) and for preparers (eg systems changes).

BC18 IFRS 4 *Insurance Contracts* provides a temporary exemption from paragraphs 10-12 of IAS 8. That exemption is broader than in IFRS 6 because IFRS 4 leaves many significant aspects of accounting for insurance contracts until phase II of the Board's project on that topic. 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. In contrast, IFRS 6 leaves a relatively narrow range of issues unaddressed and the Board did not think that an exemption from paragraph 10 of IAS 8 was necessary.

BC19 ED 6 made it clear that the Board intended to suspend only paragraphs 11 and 12 of IAS 8, implying that paragraph 10 should be followed when an entity was determining its accounting policies for exploration and evaluation assets. However, it was apparent from some comments received that the Board's intention had not been understood clearly. Consequently, the IFRS contains a specific statement that complying with paragraph 10 of IAS 8 is mandatory.

BC20 Respondents who objected to the Board's proposal in ED 6 to permit some accounting practices to continue found it difficult to draw a meaningful distinction between the exploration for and evaluation of mineral resources and scientific research. Both activities can be costly and have significant risks of failure. These respondents would support bringing the exploration for and evaluation of mineral resources within the scope of IAS 16 and IAS 38. The Board is similarly concerned that existing accounting practices might result in the inappropriate recognition of exploration and evaluation assets. However, it is also concerned that accounting for exploration and evaluation expenditures in accordance with IAS 38 might result in the overstatement of expenses. In the absence of internationally accepted standards for such expenditures, the Board concluded that it could not make an informed judgement in advance of the comprehensive review of accounting for extractive activities.

BC21 Some suggested that the Board should require an entity to follow its national accounting requirements (ie national GAAP) in accounting for the exploration for and evaluation of mineral resources until the Board completes its comprehensive review of accounting for extractive activities, to prevent the selection of accounting policies that do not form a comprehensive basis of accounting. Consistently with its conclusions in IFRS 4, the Board concluded that defining national GAAP would have posed problems. Further definitional problems could have arisen because some entities do not apply the national GAAP of their own country. For example, some non-US entities with extractive activities in the oil and gas sector apply US GAAP. Moreover, it is unusual and, arguably, beyond the Board's mandate to impose requirements set by another body.

BC22 Therefore, the Board decided that an entity could continue to follow the accounting policies that it was using when it first applied the IFRS's requirements, provided they satisfy the requirements of paragraph 10 of IAS 8 and with some exceptions noted below. An entity could also improve those accounting policies if specified criteria are met (see paragraphs 13 and 14 of the IFRS).

BC23 The Board acknowledges that it is difficult to make piecemeal changes to recognition and measurement practices at this time because many aspects of accounting for extractive activities are interrelated with aspects that will not be considered until the Board completes its comprehensive review of accounting for extractive activities. However, not imposing the requirements in the IFRS would detract from the relevance and reliability of an entity's financial statements to an unacceptable degree.

BC23A In 2008, as part of its annual improvements project, the Board considered the guidance on the treatment in IAS 7 *Statement of Cash Flows* of some types of expenditures incurred with the objective of generating future cash flows when those expenditures are not recognised as assets in accordance with IFRSs. Some entities classify such expenditures as cash flows from operating activities and others classify them as investing activities. Examples of such expenditures are those for exploration and evaluation activities, which can be recognised according to IFRS 6 as either an asset or an expense.*

BC23B The Board noted that the exemption in IFRS 6 applies only to recognition and measurement of exploration and evaluation assets, not to the classification of related expenditures in the statement of cash flows. Consequently, the Board amended paragraph 16 of IAS 7 to state that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activities.

Elements of cost of exploration and evaluation assets

BC24 ED 6 paragraph 7 listed examples of expenditures related to the exploration for and evaluation of mineral resources that might be included in the cost of an exploration and evaluation asset. ED 6 paragraph 8 listed expenditures that could not be recognised as an exploration and evaluation asset. Respondents expressed a desire for greater clarity with respect to these paragraphs and more examples of types of expenditures that would be included or excluded.

BC25 In the light of the responses, the Board decided to redraft the guidance to state that the list is not exhaustive and that the items noted are examples of expenditures that might, but need not always, satisfy the definition of exploration and evaluation expenditure. In addition, the Board noted that IFRSs require that expenditures should be treated consistently for comparable activities and between reporting periods. Any change in what is deemed to be an expenditure qualifying for recognition as an exploration and evaluation asset should be treated as a change in an accounting policy accounted for in accordance with IAS 8. Pending the comprehensive review of accounting for extractive activities, the Board does not think that it is feasible to define what expenditures should be included or excluded.

BC26 ED 6 paragraph 8 proposed to prohibit expenditure related to the development of a mineral resource from being recognised as an exploration and evaluation asset. Respondents expressed difficulty identifying expenditures on 'development'. The Board did not define 'development of a mineral resource' because this is beyond the scope of the IFRS.

BC27 However, the Board noted that development of a mineral resource once the technical feasibility and commercial viability of extracting the mineral resource had been determined was an example of the development phase of an internal project. Paragraph 57 of IAS 38 provides guidance that should be followed in developing an accounting policy for this activity.

BC28 ED 6 proposed that administration and other general overhead costs should be excluded from the initial measurement of exploration and evaluation assets. Several respondents suggested that general and administrative and overhead costs *directly attributable* to the exploration and evaluation activities should qualify for inclusion in the carrying amount of the asset. These respondents saw this treatment as consistent with the treatment of such costs with respect to inventory (paragraph 11 of IAS 2 *Inventories*) and intangible assets (paragraph 67(a) of IAS 38). However, the Board noted that such a treatment would seem to be inconsistent with paragraph 19(d) of IAS 16. The IFRS was not regarded as the appropriate Standard in which to resolve this inconsistency, and the Board decided to delete the reference in the IFRS to administrative and other general overheads. The treatment of such expenditures would be an accounting policy choice; the chosen policy should be consistent with one of the treatments available under IFRSs.

* Paragraphs BC23A and BC23B were added as a consequence of an amendment to IAS 7 included in *Improvements to IFRSs* issued in April 2009.

Measurement after recognition

BC29 The IFRS permits an entity recognising exploration and evaluation assets to measure such assets, after recognition, using either the cost model or the revaluation model in IAS 16 and IAS 38. The model chosen should be consistent with how the entity classifies the exploration and evaluation assets. Those revaluation models permit the revaluation of assets when specified requirements are met (see paragraphs 31-42 of IAS 16 and paragraphs 72-84 of IAS 38). The revaluation model in IAS 38 can be used only if the asset's fair value can be determined by reference to an active market; the revaluation model in IAS 16 refers only to 'market-based evidence'. The Board was troubled by this inconsistency and was concerned that entities might choose accounting policies to achieve a more advantageous measurement of exploration and evaluation assets.

BC30 A few respondents were also concerned with the option proposed in ED 6. Some did not agree that exploration and evaluation assets should be revalued, preferring an arbitrary prohibition of remeasurement. Others were concerned about the reliability of the measure. The Board concluded that no substantive reasons had been presented for reaching a conclusion different from that in ED 6. Although the revaluation of an exploration asset in accordance with IAS 16 or IAS 38 might not be widespread, it was not appropriate to prohibit remeasurement of specific types of IAS 16 or IAS 38 assets on a selective basis.

BC31 Exploration and evaluation assets may arise as a result of a business combination. The Board noted that IFRS 3 *Business Combinations* applies to all entities asserting compliance with IFRSs and that any exploration and evaluation assets acquired in a business combination should be accounted for in accordance with IFRS 3.

Presentation of exploration and evaluation assets

BC32 ED 6 noted that the Board had not yet considered whether exploration and evaluation assets are tangible or intangible. Several respondents suggested that the Board should give some direction on this issue.

BC33 Some exploration and evaluation assets are treated as intangible assets (eg drilling rights), whereas others are clearly tangible (eg vehicles and drilling rigs). A tangible asset may be used in the development of an intangible one. For example, a portable drilling rig may be used to drill test wells or take core samples, clearly part of the exploration activity. To the extent that the tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using the drilling rig to develop an intangible asset does not change a tangible asset into an intangible asset.

BC34 Pending completion of the comprehensive review of accounting practices for extractive activities, the Board did not wish to decide whether and which exploration and evaluation assets should be classified as tangible or intangible. However, the Board concluded that an entity should classify the elements of exploration and evaluation assets as tangible or intangible according to their nature and apply this classification consistently. This classification is the foundation for other accounting policy choices as described in paragraphs BC29-BC31 and for the disclosures required by the IFRS.

Impairment of exploration and evaluation assets

BC35 When it developed ED 6, the Board decided that an entity recognising exploration and evaluation assets should test those assets for impairment, and that the impairment test to be applied should be that in IAS 36 *Impairment of Assets*. Respondents accepted the general proposition that exploration and evaluation assets should be tested for impairment. However, the Board's proposals for a special 'cash-generating unit for exploration and evaluation assets' (the special CGU) were not thought appropriate or useful.

Assessment of impairment

BC36 In some cases, and particularly in exploration-only entities, exploration and evaluation assets do not generate cash flows and there is insufficient information about the mineral resources in a specific area for an entity to make reasonable estimates of exploration and evaluation assets' recoverable amount. This is because the exploration for and evaluation of the mineral resources has not reached a stage at which information sufficient to estimate future cash flows

is available to the entity. Without such information, it is not possible to estimate either fair value less costs to sell or value in use, the two measures of recoverable amount in IAS 36. Respondents noted that this would lead to an immediate write-off of exploration assets in many cases.

BC37 The Board was persuaded by respondents' arguments that recognising impairment losses on this basis was potentially inconsistent with permitting existing methods of accounting for exploration and evaluation assets to continue. Therefore, pending completion of the comprehensive review of accounting for extractive activities, the Board decided to change the approach to recognition of impairment; the assessment of impairment should be triggered by changes in facts and circumstances. However, it also confirmed that, once an entity had determined that an exploration and evaluation asset was impaired, IAS 36 should be used to measure, present and disclose that impairment in the financial statements, subject to special requirements with respect to the level at which impairment is assessed.

BC38 Paragraph 12 of ED 6 proposed that an entity that had recognised exploration and evaluation assets should assess those assets for impairment annually and recognise any resulting impairment loss in accordance with IAS 36. Paragraph 13 proposed a set of indicators of impairment that an entity would consider in addition to those in IAS 36. Respondents stated that these indicators would not achieve the Board's intended result, especially in circumstances in which the information necessary for an assessment of mineral reserves was not available.

BC39 The Board replaced the proposals in paragraphs 12 and 13 of ED 6 with an exception to the recognition requirements in IAS 36. The Board decided that, until the entity had sufficient data to determine technical feasibility and commercial viability, exploration and evaluation assets need not be assessed for impairment. However, when such information becomes available, or other facts and circumstances suggest that the asset might be impaired, the exploration and evaluation assets must be assessed for impairment. The IFRS suggests possible indicators of impairment.

The level at which impairment is assessed

BC40 When it developed ED 6, the Board decided that there was a need for consistency between the level at which costs were accumulated and the level at which impairment was assessed. Without this consistency, there was a danger that expenditures that would form part of the cost of an exploration and evaluation asset under one of the common methods of accounting for the exploration for and evaluation of mineral resources would need to be recognised in profit or loss in accordance with IAS 36. Consequently, ED 6 proposed that an entity recognising exploration and evaluation assets should make a one-time election to test those assets either at the level of the IAS 36 cash-generating unit (CGU) or at the level of a special CGU. ED 6 explained that any assets other than exploration and evaluation assets included within the special CGU should continue to be subject to separate impairment testing in accordance with IAS 36, and that impairment test should be performed before the special CGU was tested for impairment.

BC41 Respondents disagreed with the Board's proposal. In particular, and for various reasons, they did not accept that the special CGU would provide the relief it was intended to provide, because:

(a) small, start-up or exploration-only entities might not have adequate cash flows to support exploration and evaluation assets that were not cash-generating.

(b) entities applying the successful efforts method of accounting typically conduct impairment tests property by property. However, because of the way in which the special CGU was defined in ED 6 such entities would be forced to carry out impairment tests at the CGU level.

(c) the special CGU permitted management extensive discretion.

In addition, there was concern that, because the exploration and evaluation assets could be aggregated with other assets in the special CGU, there would be confusion about the appropriate measurement model to apply (fair value less costs to sell or value in use). As a result, many respondents to ED 6 did not think that the Board had achieved its intention in this respect, and said that they preferred to apply IAS 36 without the special CGU.

BC42 Although the Board disagreed with some of the arguments put forward by respondents, it acknowledged that the special CGU seemed to be more confusing than helpful. This suggested that it was not needed. Paragraph BC20 of the Basis for Conclusions on ED 6 noted the Board's reluctance to introduce a special CGU. Removing the special CGU would eliminate much of the complexity in the proposed IFRS and the confusion among constituents. It would also mean that entities with extractive activities would assess their assets for impairment at the same level as other entities—providing a higher level of comparability than might otherwise be the case.

BC43 Board members noted that paragraph 22 of IAS 36 requires impairment to be assessed at the individual asset level 'unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets'. In addition, paragraph 70 of IAS 36 requires that 'if an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit'. In some cases in which exploration and evaluation assets are recognised, eg in the petroleum sector, each well is potentially capable of producing cash inflows that are observable and capable of reliable measurement because there is an active market for crude oil. The Board was concerned that removing the special CGU would cause entities recognising exploration and evaluation assets to test for impairment at a very low level.

BC44 The issue was highlighted in the July 2004 issue of *IASB Update*, in the project summary and in the *Effect of Redeliberations* documents available on the IASB's Website. These documents were also sent to the Board's research project team and others with a request to encourage their constituents to respond to the issues raised. The Board received 16 comment letters.

BC45 The majority of respondents continued to support the elimination of the special CGU. They also supported the notion that entities should test impairment at the level of the cost centre and suggested that the Board should consider defining an 'asset' as it applied to exploration and evaluation assets. The respondents argued that such an approach would reflect more accurately the way in which the industry manages its operations. The Board was persuaded by these arguments and decided that it should permit entities some flexibility in allocating exploration and evaluation assets to cash-generating units or groups of units, subject to an upper limit on the size of the units or groups of units.

BC46 The Board decided that its approach to the impairment of goodwill in the 2004 revisions to IAS 36 paragraphs 80-82 offered the best model available within IFRSs to accomplish its objective. It noted that entities might be able to monitor exploration and evaluation assets for internal management purposes at the level of an oilfield or a contiguous ore body. The Board did not intend to require impairment to be assessed at such a low level. Consequently, the IFRS permits CGUs to be aggregated. However, the Board decided to require the level at which impairment was assessed to be no larger than a segment, based on either the entity's primary or the entity's secondary segment reporting format in accordance with IAS 14 *Segment Reporting*. The Board concluded, consistently with the approach to goodwill in IAS 36, that this approach was necessary to ensure that entities managed on a matrix basis could test exploration and evaluation assets for impairment at the level of reporting that reflects the way they manage their operations. This requirement is no less rigorous than ED 6's requirement that the special CGU should 'be no larger than a segment'*.

BC47 Consequently, the Board decided to remove the proposed special CGU. In doing so, it noted that eliminating this requirement would have the following benefits:

(a) once an impairment was identified, the measurement, presentation and disclosure of impairment would be more consistent across entities recognising exploration and evaluation assets.

(b) it would remove the confusion about what practices entities recognising exploration and evaluation assets for the first time should follow.

(c) it would remove the risk noted in some comment letters that the special CGU could become the 'industry norm', limiting the Board's options when the comprehensive review of accounting for extractive activities is completed.

* In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*, which does not require the identification of primary and secondary segments. See paragraph BC150A of the Basis for Conclusions on IAS 36 *Impairment of Assets*.

Reversal of impairment losses

BC48 The reversal of impairment losses when specified requirements (ie those set out in paragraphs 109-123 of IAS 36) are met is required of all entities for all assets (excluding goodwill and equity investments classified as available for sale). Respondents to ED 6 who commented on this issue and who disagreed with the ability to reverse impairment losses advanced no new arguments why the Board should prohibit reversal of impairment losses in the case of exploration and evaluation assets. Consequently, the Board reaffirmed its conclusion that it would not be appropriate to propose an exemption from the requirement to reverse impairment losses for exploration and evaluation assets.

Changes in accounting policies

BC49 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 this IFRS, it did not believe it should exempt entities from the requirement to justify changes in accounting policies. Consistently with its conclusions in IFRS 4, the Board decided to permit changes in accounting policies for exploration and evaluation assets if they make the financial statements more relevant and no less reliable, or more reliable and no less relevant judged by the criteria in IAS 8.

Disclosures

BC50 The disclosure requirements in the IFRS are based on a principle that an entity should disclose information that identifies and explains the amounts recognised in its financial statements that arise from the exploration for and evaluation of mineral resources, supplemented by specified disclosures to meet that objective.

BC51 Although respondents agreed that entities should be allowed flexibility in determining the levels of aggregation and amount of disclosure, they suggested that the Board should introduce more specific and standardised disclosure requirements. Some respondents were concerned that the variety of accounting for the exploration for and evaluation of mineral resources could reduce comparability.

BC52 The Board concluded that the ED 6 approach was superior to requiring a long list of detailed and prescriptive disclosures because concentrating on the underlying principle:

(a) makes it easier for entities to understand the rationale for the requirements, which promotes compliance.

(b) avoids requiring specific disclosures that may not be needed to meet the underlying objectives in the circumstances of every entity and could lead to information overload that obscures important information in a mass of detail.

(c) gives entities 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.

(d) permits reporting exploration and evaluation expenditure by segment on either an annual basis or an accumulated basis.

BC53 Some respondents suggested that the Board should require disclosures similar to those in paragraphs 73 and 74 of IAS 16 or in paragraphs 118-125 of IAS 38. Both IAS 16 and IAS 38 contain scope exclusions for exploration and evaluation assets. Therefore, entities recognising these assets could claim that the requirements were not applicable. The Board decided that, although the scope of those standards excludes exploration and evaluation assets, their required disclosures would provide information relevant to an understanding of the financial statements and useful to users. Consequently, the Board concluded that the IFRS should confirm that the disclosures of IASs 16 and 38 are required consistently with how the entity classifies its exploration and evaluation assets (ie tangible (IAS 16) or intangible (IAS 38)).

BC54 In addition, some respondents suggested that the Board should require disclosure of non-financial information, including:

(a) commercial reserve quantities;

(b) rights to explore for, develop and produce wasting resources;

(c) disclosures about stages after exploration and evaluation; and

(d) the number of years since exploration started, and an estimation of the time remaining until a decision could be made about the technical feasibility and commercial viability of extracting the mineral resource.

Commercial reserves

BC55 The Board acknowledged that information about commercial reserve quantities is, perhaps, the most important disclosure for an entity with extractive activities. However, it noted that commercial reserves are usually determined after the exploration and evaluation stage has ended and it concluded that such disclosure was beyond the stated scope of the IFRS.

Stages after exploration and evaluation

BC56 As with commercial reserves, the Board concluded that, although information about stages after exploration and evaluation would be useful to users of financial statements, such disclosure is beyond the scope of the IFRS.

Project timing

BC57 The Board also concluded that disclosure of the number of years since exploration started and the estimated time remaining until a decision could be made about development would apply only to large scale exploration activities. It noted that if the project is significant, paragraph ~~103~~112(c) of IAS 1 already requires its disclosure, ie as additional information that is necessary for an understanding of the financial statements.

Effective date

BC58 ED 6 proposed that the IFRS should be effective for annual periods beginning on or after 1 January 2005. The Board decided to change the effective date to 1 January 2006 to allow entities more time to make the transition to the IFRS. It also decided to permit an entity that wishes or is required to adopt IFRSs before 1 January 2006 to adopt IFRS 6 early.

Transition

BC59 The Board did not propose any special transition in ED 6. Consequently, paragraphs 14-27 of IAS 8 would apply to any changes in accounting that are necessary as a result of the IFRS.

BC60 Some respondents expressed concern about the application of the proposals to prior periods—especially those related to impairment and the inclusion or exclusion of some expenditures from exploration and evaluation assets. In particular, respondents requested that if the Board were to require restatement, it should give transitional guidance on how to identify elements previously recognised as exploration and evaluation assets now outside the definition.

BC61 IAS 8 would require entities recognising exploration and evaluation assets to determine whether there were any facts and circumstances indicating impairment in prior periods. The Board concluded that retrospective application was not likely to involve the use of hindsight because the facts and circumstances identified in the IFRS are generally objective indicators and whether they existed at a particular date should be a question of fact. However, the Board noted that it provided transitional relief in IFRS 4 for applying the liability adequacy test to comparative periods on the basis of impracticability, principally because the liability adequacy test involves the use of current estimates of future cash flows from an entity's insurance contracts. The Board does not expect that IFRS 6's approach to impairment will involve current estimates of future cash flows and other variables to the same extent. However, it is aware that the variety of approaches to assessing recoverability means that current estimates of future cash flows and other variables are likely to be in use by some entities.

BC62 Therefore, consistently with IFRS 4, the Board concluded that if it is impracticable to apply the impairment test to comparative information that relates to annual periods beginning before 1 January 2006, an entity should disclose that fact.

BC63 Some respondents were concerned that entities would have difficulty in compiling the information necessary for 2004 comparative figures, and suggested that entities should be exempted from restating comparatives on transition, given that the IFRS would be introduced close to 1 January 2005, and could result in substantial changes.

BC64 The Board considered a similar issue when it developed ED 7 *Financial Instruments: Disclosures*, in which it concluded that entities that apply the requirements proposed in ED 7 only when they become mandatory should be required to provide comparative disclosures because such entities will have enough time to prepare the information.

BC65 In ED 7, the Board decided to propose that an entity that both (a) adopts IFRSs for the first time before 1 January 2006 and (b) applies the IFRS before that date should be exempt from the requirement to produce comparative information in the first year of application. The Board compared the concerns raised by constituents in response to ED 6 and the issues it considered in developing ED 7 and decided that its conclusions in ED 7 were also appropriate for the IFRS.

BC65A ~~In June 2005, the Board made a minor amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* paragraph 36B to clarify its intention that the exemption provided in this paragraph applies to the recognition and measurement requirements of IFRS 6, as well as the disclosure requirements.~~ [Deleted][*]

Summary of changes from ED 6

BC66 The following is a summary of the main changes from ED 6 to the IFRS. The Board:

(a) deleted the specific prohibition against including administration and other general overhead costs in the initial measurement of an exploration and evaluation asset (paragraph BC28).

(b) introduced a requirement for the entity to classify exploration and evaluation assets as either tangible or intangible according to the nature of the asset acquired and to apply this classification consistently (paragraphs BC32-BC34).

(c) amended the impairment principle so that an impairment is recognised on the basis of an assessment of facts and circumstances and measured, presented and disclosed in accordance with IAS 36, subject to the modification of the level at which the impairment is assessed (paragraphs BC36-BC39).

(d) deleted the indicators of impairment proposed in ED 6 and replaced them with examples of facts and circumstances that would suggest that an exploration and evaluation asset was impaired (paragraphs BC36-BC39).

(e) deleted the special cash-generating unit for exploration and evaluation assets and instead required that the entity determine an accounting policy for allocating exploration and evaluation assets to a cash-generating unit or units for the purpose of the impairment test (paragraphs BC40-BC47).

(f) amended the effective date of the IFRS so that the IFRS is effective for annual periods beginning on or after 1 January 2006 (paragraph BC58).

(g) provided transitional relief for entities adopting IFRSs for the first time and adopting the IFRS before 1 January 2006 (paragraphs BC59-BC65).

[*] Paragraph BC65A was deleted as a result of revisions to IFRS 1 *First-time Adoption of International Financial Reporting Standards* in November 2008 as it was no longer applicable.

Dissenting opinions on IFRS 6

Dissent of Robert P Garnett, James J Leisenring, Warren J McGregor and John T Smith

DO1 Messrs Garnett, Leisenring, McGregor and Smith dissent from the issue of IFRS 6.

DO2 These four Board members dissent because they would not permit entities the alternative of continuing their existing accounting treatment for exploration and evaluation assets. In particular, they believe that all entities should be required to apply paragraphs 11 and 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when developing an accounting policy for exploration and evaluation assets. These Board members believe that the requirements in IAS 8 have particular relevance and applicability when an IFRS lacks specificities, as is the case for entities recognising exploration and evaluation assets. This is especially true because the IFRS allows the continuation of a variety of measurement bases for these items and, because of the failure to consider the *Framework*, may result in the inappropriate recognition of assets. In the view of these Board members, if an entity cannot meet those requirements, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.

DO3 Messrs Garnett and McGregor also disagree with the modifications to the requirements of IAS 36 for the purpose of assessing exploration and evaluation assets for impairment contained in paragraphs 18-22 of the IFRS. They think that the requirements of IAS 36 should be applied in their entirety to exploration and evaluation assets. Failure to do so could result in exploration and evaluation assets continuing to be carried forward when such assets are not known to be recoverable. This could result in the exclusion of relevant information from the financial statements because of the failure to recognise impairment losses on a timely basis and the inclusion of unreliable information because of the inclusion of assets that do not faithfully represent the transactions and other events that they purport to represent.

DO4 The four Board members' concerns are heightened by the absence as yet from the Board's main agenda of a project on accounting for exploration for and evaluation of mineral resources generally. Although a research project has begun, it is unlikely that the Board will be able to develop financial reporting standards in the medium term. Accordingly, it is likely that the concession referred to in paragraph DO2 and, in Messrs Garnett and McGregor's cases, in paragraph DO3, will remain in place for some time.