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

MEMBERS' HANDBOOK

Update No. 152

(Issued 10 July 2014)

Handbook Improvements only

Document Reference and Title	***Instructions***	***Explanations***

VOLUME II

Contents of Volume II	Insert the revised pages i - iii. Discard the replaced pages i - iii.	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 2013 in the relevant affected Standards, Basis for Conclusions and Implementation Guidance, for greater clarity.

This Update also relates to the withdrawal of Standards and Interpretations which have been superseded by the issuance of revised Standards and Interpretations.

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKAS 19 *Employee Benefits*	Discard HKAS 19.	HKAS 19 has been superseded by HKAS 19 (2011) for annual periods beginning on or after 1 January 2013
HKAS 27 (Revised) *Consolidated and Separate Financial Statements*	Discard HKAS 27 (Revised).	HKAS 27 (Revised) has been superseded by HKAS 27 (2011) and HKFRS 10 for annual periods beginning on or after 1 January 2013
HKAS 28 *Investments in Associates*	Discard HKAS 28.	HKAS 28 has been superseded by HKAS 28 (2011) for annual periods beginning on or after 1 January 2013

HKAS 31 *Interests in Joint Ventures*	Discard HKAS 31.	HKAS 31 has been superseded by HKFRS 11 for annual periods beginning on or after 1 January 2013
HKAS 39 *Financial Instruments: Recognition and Measurement* (Standard)	Replace the cover page, pages 2-5, 8-9, 11-12, 15, 17, 19, 23, 26-28, 37, 43, 49, 53, 64-65, 67, 72, 75-80 and 83 with revised cover page, pages 2-5, 8-9, 11-12, 15, 17, 19, 23, 26-28, 37, 43, 49, 53, 64-65, 67, 72, 75-80 and 83. Insert page 43A after page 43 and page 77A after page 77.	Amendments due to - HKFRS 10 *Consolidated Financial Statements* - HKFRS 11 *Joint Arrangements* - HKFRS 13 *Fair Value Measurement*
HKAS 39 *Financial Instruments* (Basis for Conclusions)	Replace the cover page, pages 2-5, 8, 20, 31-36 and 38 with revised cover page, pages 2-5, 8, 20, 31-36 and 38.	
HKAS 39 *Impairment of Assets* (Implementation Guidance)	Replace the cover page, pages 82 and 85 with revised cover page, pages 82 and 85.	

HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)

HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* (Standard and Basis for Conclusions)	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions.	Amendments due to - *Presentation of Items of Other Comprehensive Income* (Amendment to HKAS 1) - HKAS 19 (2011) *Employee Benefits* - *Government Loans* (Amendment to HKFRS 1) - HKFRS 10 *Consolidated Financial Statements* - HKFRS 11 *Joint Arrangements* - *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendment to HKFRS 10, HKFRS 11 and HKFRS 12) - HKFRS 13 *Fair Value Measurement* - *Annual Improvements to HKFRSs 2009-2011 Cycle*

		- HK(IFRIC) – Int 20 *Stripping Costs in the Production Phase of a Surface Mine*
HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* (Implementation Guidance)	Replace the cover page, pages 2-3, 8, 16 and 30 with revised cover page, pages 2-3, 8, 16 and 30. Insert page 30A after page 30. Discard pages 32A and 32B.	
HKFRS 3 *Business Combinations* (Standard)	Replace the cover page, pages 1A, 2-3, 5, 9, 11-13, 16, 19, 19A, 20, 24, 26, 29-31, 36 and 38 with revised cover page, pages 1A, 2-3, 5, 9, 11-13, 16, 19, 19A, 20, 24, 26, 29-31, 36 and 38.	Amendments due to - HKFRS 10 *Consolidated Financial Statements* - HKFRS 13 *Fair Value Measurement*
HKFRS 3 *Business Combinations* (Basis for Conclusions)	Replace the cover page, pages 2-5, 17, 24, 35, 43, 47, 52, 56, 64, 71, 88 and 91 with revised cover page, pages 2-5, 17, 24, 35, 43, 47, 52, 56, 64, 71, 88 and 91.	
HKFRS 3 *Business Combinations* (Illustrative Examples)	Replace the cover page, pages 2, 4, 19-20 and 23-24 with revised cover page, pages 2, 4, 19-20 and 23-24.	

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

HK(IFRIC)-Int 8 *Scope of HKFRS 2*	Discard HK(IFRIC)-Int 8.	Guidance included in HK(IFRIC)-Int 8 has been incorporated into HKFRS 2.
HK(IFRIC)-Int 11 *HKFRS 2-Group and Treasury Share Transactions*	Discard HK(IFRIC)-Int 11.	Guidance included in HK(IFRIC)-Int 11 has been incorporated into HKFRS 2.

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

HK(SIC)-Int 12 *Consolidation – Special Purpose Entities*	Discard HK(SIC)-Int 12.	HK(SIC)-Int 12 has been superseded by HKFRS 10 for annual periods beginning on or after 1 January 2013
HK(SIC)-Int 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*	Discard HK(SIC)-Int 13.	HK(SIC)-Int 13 has been superseded by HKFRS 11 for annual periods beginning on or after 1 January 2013

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MEMBERS' HANDBOOK
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(Updated to July 2014)

*Note: * With effect from 24 May 2005, all Interpretations that are developed locally by the Institute are named Hong Kong Interpretations.*

HKAS 39
Revised July ~~2013~~2014

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

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

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from paragraph

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 1-109 and Appendices A-C. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting.* HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

IN12 The Standard states that an entity has transferred a financial asset if, and only if, it either:

(a) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets three specified conditions; or

(b) transfers the contractual rights to receive the cash flows of a financial asset.

IN13 Under the Standard, if an entity has transferred a financial asset, it assesses whether it has transferred substantially all the risks and rewards of ownership of the transferred asset. If an entity has retained substantially all such risks and rewards, it continues to recognise the transferred asset. If it has transferred substantially all such risks and rewards, it derecognises the transferred asset.

IN14 The Standard specifies that if an entity has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred asset, it assesses whether it has retained control over the transferred asset. If it has retained control, the entity continues to recognise the transferred asset to the extent of its continuing involvement in the transferred asset. If it has not retained control, the entity derecognises the transferred asset.

IN15 The Standard provides guidance on how to apply the concepts of risks and rewards and of control.

Measurement: fair value option

IN16 An amendment to the Standard, issued in July 2005, permits an entity to designate a financial asset or financial liability (or a group of financial assets, financial liabilities or both) on initial recognition as one(s) to be measured at fair value, with changes in fair value recognised in profit or loss. To impose discipline on this categorisation, an entity is precluded from reclassifying financial instruments into or out of this category.

IN17 [Not used]

~~How to determine fair value~~

~~IN18~~ [Deleted]~~The Standard provides certain guidance about how to determine fair values using valuation techniques.~~

- ~~The objective is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.~~

- ~~A valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments.~~

- ~~In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions that market participants would use in setting a price for the financial instrument.~~

- ~~The best estimate of fair value at initial recognition of a financial instrument that is not quoted in an active market is the transaction price unless the fair value of the instrument is evidenced by other observable market transactions or is based~~

~~on a valuation technique whose variables include only data from observable markets.~~

~~IN19~~ [Deleted]~~The Standard also states that the fair value of a liability with a demand feature, eg a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.~~

Impairment of financial assets

IN20 The Standard states that an impairment loss is recognised only when it has been incurred. It also provides certain guidance on what events provide objective evidence of impairment for investments in equity instruments.

IN21 The Standard provides certain guidance about how to evaluate impairment that is inherent in a group of loans, receivables or held-to-maturity investments, but cannot yet be identified with any individual financial asset in the group, as follows:

- An asset that is individually assessed for impairment and found to be impaired should not be included in a group of assets that are collectively assessed for impairment.
- An asset that has been individually assessed for impairment and found not to be individually impaired should be included in a collective assessment of impairment. The occurrence of an event or a combination of events should not be a precondition for including an asset in a group of assets that are collectively evaluated for impairment.
- When performing a collective assessment of impairment, an entity groups assets by similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms.
- Contractual cash flows and historical loss experience provide the basis for estimating expected cash flows. Historical loss rates are adjusted on the basis of relevant observable data that reflect current economic conditions.
- The methodology for measuring impairment should ensure that an impairment loss is not recognised on the initial recognition of an asset.

IN22 The Standard requires that impairment losses on available-for-sale equity instruments cannot be reversed through profit or loss, ie any subsequent increase in fair value is recognised in other comprehensive income.

Hedge accounting

IN23 Hedges of firm commitments are treated as fair value hedges rather than cash flow hedges. However, the Standard states that a hedge of the foreign currency risk of a firm commitment can be treated as either a cash flow hedge or a fair value hedge.

IN24 The Standard requires that when a hedged forecast transaction occurs and results in the recognition of a *financial* asset or a *financial* liability, the gain or loss recognised in other comprehensive income does not adjust the initial carrying amount of the asset or liability (ie basis adjustment is prohibited), but remains in equity and is reclassified from equity to profit or loss consistently with the recognition of gains and losses on the asset or liability as a reclassification adjustment. For hedges of forecast transactions that result in the

Hong Kong Accounting Standard 39
Financial Instruments: Recognition and Measurement

Objective

1 The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in HKAS 32 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in HKFRS 7 *Financial Instruments: Disclosures*.

Scope

2 This Standard shall be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for ~~under~~ in accordance with HKFRS 10 *Consolidated Financial Statements,* HKAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*~~,~~or HKAS 28 *Investments in Associates and Joint Ventures* ~~or HKAS 31 *Interests in Joint Ventures*~~. However, in some cases, HKFRS 10, HKAS 27 or HKAS 28 require or permit an entity to account for ~~entities shall apply this Standard to~~ an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. ~~that according to HKAS 27, HKAS 28 or HKAS 31 is accounted for under this Standard.~~ Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in HKAS 32.

(b) rights and obligations under leases to which HKAS 17 *Leases* applies. However:

(i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15-37, 58, 59, 63-65 and Appendix A paragraphs AG36-AG52 and AG84-AG93);

(ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63); and

(iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).

(c) employers' rights and obligations under employee benefit plans, to which HKAS 19 *Employee Benefits* applies.

(d) financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.

(e) rights and obligations arising under (i) an insurance contract as defined in HKFRS 4 *Insurance Contracts* other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract that is within the scope of HKFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of HKFRS 4 if the derivative is not itself a contract within the scope of HKFRS 4 (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33 of this standard). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(f) [deleted]

(g) any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination <u>within the scope of HKFRS 3 *Business Combinations*</u> at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

(h) loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15-42 and Appendix A paragraphs AG36-AG63).

(i) financial instruments, contracts and obligations under share-based payment transactions to which HKFRS 2 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies.

(j) rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance with HKAS 37, or for which, in an earlier period, it recognised a provision in accordance with HKAS 37.

3 [Deleted]

4 The following loan commitments are within the scope of this Standard:

(a) loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors and chief executive officer.

In HKFRS 7, paragraphs 9-11 and B4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.

It should be noted that HKFRS 13 Fair Value Measurement ~~paragraphs 48, 48A, 49 and Appendix A paragraphs AG69-AG82, which~~ sets out the requirements for ~~determining a reliable measure of~~measuring the fair value of a financial asset or financial liability, ~~apply equally to all items that are measured at fair value,~~ whether by designation or otherwise, or whose fair value is disclosed.

Held-to-maturity investments **are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG16-AG25) other than:**

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity designates as available for sale; and

(c) those that meet the definition of loans and receivables.

An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

(i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;

parties to the contract that are an integral part of the effective interest rate (see HKAS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Derecognition **is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.**

Fair value **is the ~~amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.~~[*] price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13)**

A *regular way purchase or sale* **is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.**

Transaction costs **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.**

Definitions relating to hedge accounting

A *firm commitment* **is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.**

A *forecast transaction* **is an uncommitted but anticipated future transaction.**

A *hedging instrument* **is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72-77 and Appendix A paragraphs AG94-AG97 elaborate on the definition of a hedging instrument).**

A *hedged item* **is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 78-84 and Appendix A paragraphs AG98-AG101 elaborate on the definition of hedged items).**

Hedge effectiveness **is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113).**

[*] ~~Paragraphs 48, 49 and AG69-AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.~~

12 **If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.**

13 If an entity is unable to ~~determine~~ measure reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an ~~unquoted~~ equity instrument that does not have a quoted price in an active market for an identical instrument, ie a Level 1 input), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract~~, if those can be determined under this Standard~~. If the entity is unable to ~~determine~~ measure the fair value of the embedded derivative using this method, paragraph 12 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.

Recognition and derecognition

Initial recognition

14 **An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)**

Derecognition of a financial asset

15 In consolidated financial statements, paragraphs 16-23 and Appendix A paragraphs AG34-AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with ~~HKAS 27 and SIC-12 *Consolidation—Special Purpose Entities*~~ HKFRS 10 and then applies paragraphs 16-23 and Appendix A paragraphs AG34-AG52 to the resulting group.

16 **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.**

(a) Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.

fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:

(a) the carrying amount allocated to the part derecognised and

(b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))

shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.

28 When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be ~~determined~~ measured. When the entity has a history of selling parts similar to the part that continues to be recognised or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.

Transfers that do not qualify for derecognition (see paragraph 20(b))

29 If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

Continuing involvement in transferred assets (see paragraph 20(c)(ii))

30 If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

(a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

(b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is

41 **The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.**

42 If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

Measurement

Initial measurement of financial assets and financial liabilities

43 **When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.**

43A **However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph AG76.**

44 When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see Appendix A paragraphs AG53-AG56).

Subsequent measurement of financial assets

45 For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 9:

(a) financial assets at fair value through profit or loss;

(b) held-to-maturity investments;

(c) loans and receivables; and

(d) available-for-sale financial assets.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information in the financial statements. The entity shall disclose in the notes the information required by HKFRS 7.

46 **After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:**

(a) **loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;**

(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58-70 and Appendix A paragraphs AG84-AG93.

Subsequent measurement of financial liabilities

47 **After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:**

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an ~~unquoted~~ equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) whose fair value cannot otherwise be reliably measured, which shall be measured at cost.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities

(c) financial guarantee contracts as defined in paragraph 9. After initial recognition, an issuer of such a contract shall (unless paragraph 47(a) or (b) applies) measure it at the higher of:

(i) the amount determined in accordance with HKAS 37; and

(ii) the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18.

(d) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 47(a) applies) measure it at the higher of:

(i) the amount determined in accordance with HKAS 37; and

(ii) the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 89-102.

~~Fair value measurement considerations~~

48 - 49 [Deleted]~~In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, HKAS 32 or HKFRS 7, an entity shall apply paragraphs AG69-AG82 of Appendix A.~~

~~48A The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data.~~

~~49 The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.~~

Reclassifications

50 An entity:

(a) shall not reclassify a derivative out of the fair value through profit or loss category while it is held or issued;

(b) shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss; and

(c) may, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through profit or loss category if the requirements in paragraph 50B or 50D are met.

An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.

50A The following changes in circumstances are not reclassifications for the purposes of paragraph 50:

(a) a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

Hedge accounting

85 Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.

86 Hedging relationships are of three types:

(a) *fair value hedge*: **a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.**

(b) *cash flow hedge*: **a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.**

(c) *hedge of a net investment in a foreign operation* **as defined in HKAS 21.**

87 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

88 A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured~~ (see paragraphs 46 and 47 and Appendix A paragraphs AG80 and AG81 for guidance on determining fair value)~~.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

103H *Reclassification of Financial Assets* (Amendments to HKAS 39 and HKFRS 7), issued in October 2008, amended paragraphs 50 and AG8, and added paragraphs 50B–50F. An entity shall apply those amendments on or after 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B, 50D or 50E before 1 July 2008. Any reclassification of a financial asset made on or after 1 November 2008 shall take effect only from the date when the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B, 50D or 50E shall not be applied retrospectively before 1 July 2008.

103I *Reclassification of Financial Assets—Effective Date and Transition* (Amendments to HKAS 39 and HKFRS 7), issued in December 2008, amended paragraph 103H. An entity shall apply that amendment on or after 1 July 2008.

103J An entity shall apply paragraph 12, as amended by *Embedded Derivatives* (Amendments to HK(IFRIC)-Int 9 and HKAS 39), issued in March 2009, for annual periods ending on or after 30 June 2009.

103K *Improvements to HKFRSs* issued in May 2009 amended paragraphs 2(g), 97, 100 and AG30(g). An entity shall apply the amendments to paragraphs 2(g), 97 and 100 prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. An entity shall apply the amendment to paragraph AG30(g) for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

103L-103M *[These paragraphs refer to amendments that are not yet effective, and are therefore not included in this edition.]*

103N Paragraph 103D was amended by *Improvements to HKFRSs* issued in May 2010. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted.

103O *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

103P HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 2(a), 15, AG3, AG36-AG38 and AG4I(a). An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.

103Q HKFRS 13, issued in June 2011, amended paragraphs 9, 13, 28, 47, 88, AG46, AG52, AG64, AG76, AG76A, AG80, AG81 and AG96, added paragraph 43A and deleted paragraphs 48-49, AG69-AG75, AG77-AG79 and AG82. An entity shall apply those amendments when it applies HKFRS 13.

104 The transition to this Standard should be as follows:

(a) [not used]

(b) for those transactions entered into before the beginning of the financial year in which this Standard is initially applied that the entity did previously designate as hedges, the recognition, derecognition, and measurement provisions of this Standard should be applied prospectively. Therefore, if the previously designated hedge does not meet the conditions for an effective hedge set out in paragraph 88 and the hedging instrument is still held, hedge accounting will no longer be appropriate starting with the beginning of the financial year in which this Standard is initially applied. Accounting in prior financial years should not be retrospectively changed to conform to the requirements of this Standard. Paragraphs 91 and 101 explain how to discontinue hedge accounting;

(c) at the beginning of the financial year in which this Standard is initially applied, an entity should recognise all derivatives in its statement of financial position as either assets or liabilities and should measure them at fair value (except for a derivative that is linked to and that must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably). Because all derivatives, other than those that are designated hedging instruments, are considered held for trading, the difference between previous carrying amount (which may have been zero) and fair value of derivatives should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which

Appendix A
Application guidance

This appendix is an integral part of the Standard.

Scope (paragraphs 2-7)

AG1 Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.). If those contracts are not within the scope of HKFRS 4, they are within the scope of this Standard.

AG2 This Standard does not change the requirements relating to employee benefit plans that comply with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans* and royalty agreements based on the volume of sales or service revenues that are accounted for under HKAS 18.

AG3 Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor or joint venturer entity uses HKAS 28 to determine whether the equity method of accounting is appropriate for such an investment. ~~Similarly, the investor entity uses HKAS 31 to determine whether proportionate consolidation or the equity method is appropriate for such an investment.~~ If ~~neither~~ the equity method ~~nor proportionate consolidation~~ is not appropriate, the entity applies this Standard to that strategic investment.

AG3A This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of HKFRS 4.

AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in HKFRS 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and AG47–AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. HKAS 28 ~~and HKAS 31~~ allows such investments to be ~~excluded from their scope provided they are~~ measured at fair value through profit or loss in accordance with this Standard. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of HKAS 28~~ or HKAS 31~~.

(b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.

(c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (ie interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (eg a year) or are subject to the insurer's discretion.

AG4J As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.

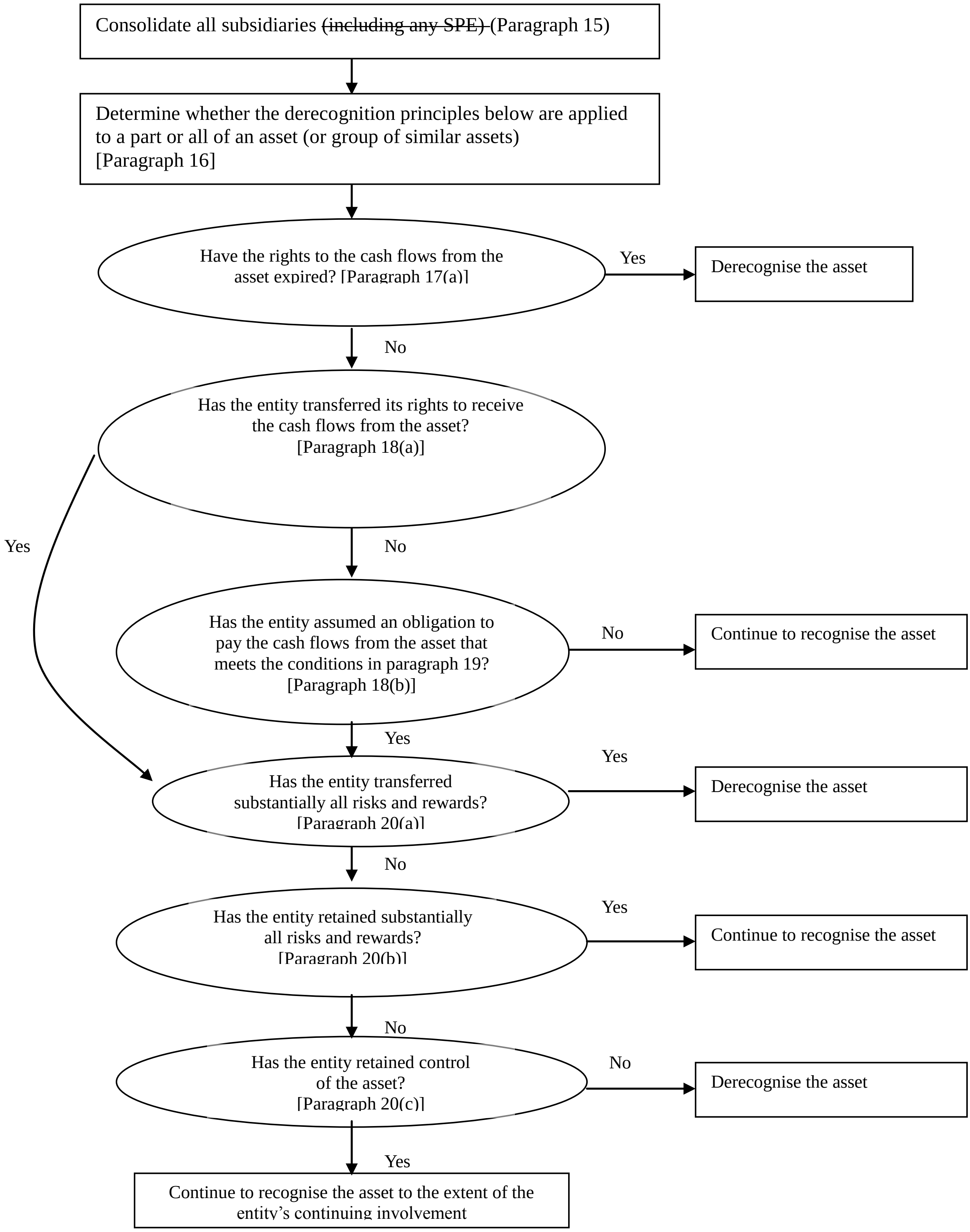
AG4K Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).

Effective interest rate

AG5 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

Derecognition of a financial asset (paragraphs 15-37)

AG36 The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 18(b))

AG37 The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a ~~special purpose entity or~~ trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.

AG38 In applying paragraph 19, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a ~~consolidated special purpose entity~~ subsidiary that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 20)

AG39 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;

(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

AG40 Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

AG41 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

AG46 ~~In estimating~~ When measuring the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in HKFRS 13 ~~paragraphs 48-49 and AG69-AG82~~ in addition to paragraph 28.

Transfers that do not qualify for derecognition

AG47 The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing involvement in transferred assets

AG48 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis (see HKAS 18) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

(b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (ie the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

AG52 This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining CU9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is CU10,100 and the ~~estimated~~ fair value of the excess spread of 0.5 per cent is CU40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this Standard, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of CU1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that CU9,090 (90 per cent CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

	~~Estimated~~ ~~fair~~ Fair value	*Percentage*	*Allocated carrying amount*
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	**10,100**		**10,000**

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, ie CU90 (CU9,090 – CU9,000). The carrying amount of the portion retained by the entity is CU1,000.

AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

AG63 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Measurement (paragraphs 43-70)

Initial measurement of financial assets and financial liabilities (paragraph 43)

AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also HKFRS 13 and paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument~~ is estimated, using a valuation technique (see paragraphs AG74-AG79)~~. For example, the fair value of a long-term loan or receivable that carries no interest can be ~~estimated ~~measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

AG65 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest ~~rate ~~method.

Subsequent measurement of financial assets (paragraphs 45 and 46)

AG66 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability in accordance with paragraph 47.

AG67 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognised at CU102. The end of the reporting period occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognised in other comprehensive income. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

AG68 Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity.

~~Fair value measurement considerations (paragraphs 48 and 49)~~

AG69 - AG75 [Deleted]~~Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.~~

~~AG70 This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (eg for counterparty credit risk) are not included in the term 'bid-ask spread'.~~

~~Active market: quoted price~~

~~AG71 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.~~

~~AG72 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in~~

~~economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (eg a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (eg because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.~~

~~AG73 If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.~~

~~No active market: valuation technique~~

~~AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.~~

~~AG75 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.~~

AG76 ~~Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased.~~ The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also HKFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 43A, the entity shall account for ~~unless the fair value of~~ that instrument at that date as follows:

(a) at the measurement required by paragraph 43 if that fair value is evidenced by ~~comparison with other observable current market transactions in the same instrument (ie without modification or repackaging)~~ a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique ~~whose variables include~~ that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 43, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

AG76A The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. ~~The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, HKAS 39 requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.~~

AG77 – AG 79 [Deleted]~~The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.~~

~~AG78 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.~~

~~AG79 In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.~~

No active market: equity instruments

AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market for an identical instrument (ie a Level 1 input) and derivatives that are linked to and must be settled by delivery of such an ~~unquoted~~ equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value ~~estimates~~ measurements is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used ~~in estimating~~ when measuring fair value.

AG81 There are many situations in which the variability in the range of reasonable fair value ~~estimates~~ measurements of investments in equity instruments that do not have a quoted ~~market~~ price in an active market for an identical instrument (ie a Level 1 input) and derivatives that are linked to and must be settled by delivery of such an ~~unquoted~~ equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to ~~estimate~~ measure the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value ~~estimates~~ measurements is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

~~Inputs to valuation techniques~~

AG82 [Deleted]~~An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).~~

~~(a)~~ ~~*The time value of money (ie interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.~~

~~(b)~~ ~~*Credit risk.* The effect on fair value of credit risk (ie the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.~~

~~(c)~~ ~~*Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.~~

~~(d) *Commodity prices*. There are observable market prices for many commodities.~~

~~(e) *Equity prices*. Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.~~

~~(f) *Volatility (ie magnitude of future changes in price of the financial instrument or other item)*. Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.~~

~~(g) *Prepayment risk and surrender risk*. Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount – see paragraph 49.)~~

~~(h) *Servicing costs for a financial asset or a financial liability*. Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.~~

Gains and losses (paragraphs 55-57)

AG83 An entity applies HKAS 21 to financial assets and financial liabilities that are monetary items in accordance with HKAS 21 and denominated in a foreign currency. Under HKAS 21, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95-101) or a hedge of a net investment (see paragraph 102). For the purpose of recognising foreign exchange gains and losses under HKAS 21, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in accordance with paragraph 55(b). For available-for-sale financial assets that are not monetary items under HKAS 21 (for example, equity instruments), the gain or loss that is recognised in other comprehensive income under paragraph 55(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

Interest income after impairment recognition

AG93 Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 71-102)

Hedging instruments (paragraphs 72-77)

Qualifying instruments (paragraphs 72 and 73)

AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

AG95 A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 An investment in an ~~unquoted~~ equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) is not carried at fair value because its fair value cannot otherwise be reliably measured or a derivative that is linked to and must be settled by delivery of such an ~~unquoted~~ equity instrument (see paragraphs 46(c) and 47) cannot be designated as a hedging instrument.

AG97 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged items (paragraphs 78-84)

Qualifying items (paragraphs 78-80)

AG98 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

AG99 An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

Basis for Conclusions
Hong Kong Accounting Standard 39

Financial Instruments:

Recognition and Measurement

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

CONTENTS *from paragraph*

BASIS FOR CONCLUSIONS ON IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

This Basis for Conclusions accompanies, but is not part of, IAS 39.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements *(as revised in 2007).*

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

HKAS 39 is based on IAS 39 *Financial Instruments: Recognition and Measurement*. In approving HKAS 39, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 39. Accordingly, there are no significant differences between HKAS 39 and IAS 39. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 39 referred to below generally correspond with those in HKAS 39.

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions on revising IAS 39 *Financial Instruments: Recognition and Measurement* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, with a comment deadline of 14 October 2002. In August 2003 the Board published a further Exposure Draft of Proposed Amendments to IAS 39 on *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and IAS 39, this Basis for Conclusions does not discuss requirements in IAS 39 that the Board has not reconsidered.

Background

BC4 The original version of IAS 39 became effective for financial statements covering financial years beginning on or after 1 January 2001. It reflected a mixed measurement model in which some financial assets and financial liabilities are measured at fair value and others at cost or amortised cost, depending in part on an entity's intention in holding an instrument.

BC5 The Board recognises that accounting for financial instruments is a difficult and controversial subject. The Board's predecessor body, the International Accounting Standards Committee (IASC) began its work on the issue some 15 years ago, in 1988. During the next eight years it published two Exposure Drafts, culminating in the issue of IAS 32 on disclosure and presentation in 1995. IASC decided that its initial proposals on recognition and measurement should not be progressed to a Standard, in view of:

occur, in the two situations set out in paragraph BC172C. After considering the responses, the Board decided to focus on those two situations. Rather than specifying eligible risks and portions as proposed in the exposure draft, the Board decided to address those situations by adding application guidance to illustrate how the principles underlying hedge accounting should be applied. The Board subsequently issued *Eligible Hedged Items* (Amendment to IAS 39) in July 2008. The rationale for the amendment is set out in paragraphs BC172B–BC172J.

BC11E In October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP (Statements of Financial Accounting Standards No. 115 *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115) and No. 65 *Accounting for Certain Mortgage Banking Activities* (SFAS 65) issued by the US Financial Accounting Standards Board). In response the Board issued *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008. The amendments to IAS 39 permit non-derivative financial assets held for trading and available-for-sale financial assets to be reclassified in particular situations. The rationale for the amendments is set out in paragraphs BC104A–BC104E.

BC11F Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. In response the Board issued *Embedded Derivatives* (Amendments to IFRIC 9 and IAS 39) in March 2009. The amendment to IAS 39 clarifies the consequences if the fair value of the embedded derivative that would have to be separated cannot be measured separately.

BC12 The Board did not reconsider the fundamental approach to accounting for financial instruments contained in IAS 39.[*] Some of the complexity in existing requirements is inevitable in a mixed measurement model based in part on management's intentions for holding financial instruments and given the complexity of finance concepts and fair value estimation issues. The amendments reduce some of the complexity by clarifying the Standard, eliminating internal inconsistencies and incorporating additional guidance into the Standard.

BC13 The amendments also eliminate or mitigate some differences between IAS 39 and US GAAP related to the measurement of financial instruments. Already, the measurement requirements in IAS 39 are, to a large extent, similar to equivalent requirements in US GAAP, in particular, those in FASB SFAS 114 *Accounting by Creditors for Impairment of a Loan*, SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* and SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*.

BC14 The Board will continue its consideration of issues related to the accounting for financial instruments. However, it expects that the basic principles in the improved IAS 39 will be in place for a considerable period.

Scope

Loan commitments (paragraphs 2(h) and 4)

BC15 Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. In the IAS 39 implementation guidance process, the question was raised whether a bank's loan commitments are derivatives accounted for at fair value under IAS 39. This question arises because a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. In effect, it is a

[*] In 2011 the Board's project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.

BC53 The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue. It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset is considered for derecognition only if it comprises:

(a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);

(b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or

(c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

In all other cases the derecognition principles are applied to the financial asset in its entirety.

Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 19)

BC54 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a 'pass-through arrangement'). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.

BC55 To illustrate the issue using a simple example, assume the following. Entity A makes a five-year interest-bearing loan (the 'original asset') of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?[*]

BC56 To address these issues, the Exposure Draft of proposed amendments to IAS 39 included guidance to clarify under which conditions passthrough arrangements can be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the *Framework*, when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for

[*] SIC-12 *Consolidation – Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

BC88 The Board considered comments on the Exposure Draft that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and a loan expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when a liability's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in the instrument's credit risk.

BC89 However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability[#] reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:

(a) entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;

(b) changes in credit risk affect the observed market price of a financial liability and hence its fair value;

(c) it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and

(d) the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

BC90 The Board also considered whether the component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that whilst separately presenting or disclosing such changes might be difficult in practice, disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided to include in IAS 32[*] a disclosure to help identify the changes in the fair value of a financial liability that arise from changes in the liability's credit risk. The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability’s credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.

BC91 The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity. The Board noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.[†]

BC92 The Board also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity’s creditworthiness.

BC92A IFRS 13, issued in May 2011, includes requirements for measuring the fair value of a liability issued with an inseparable third-party credit enhancement from the issuer's perspective.

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

[*] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

[†] IFRS 13, issued in May 2011, describes the objective of a fair value measurement of a liability.

Measurement of financial liabilities with a demand feature*

BC93 – BC94 [Deleted]~~Some comments received on the Exposure Draft requested clarification of how to determine fair value for financial liabilities with a demand feature (eg demand deposits), when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the 'demand amount'), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believe that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.~~

~~BC94 The Board agreed that this issue should be clarified in IAS 39. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid. This conclusion is the same as in the original IAS 32. The Board noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—ie the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the Board believes is inappropriate.~~

Fair value measurement guidance (paragraphs AG69-AG82)#

BC95 The Board decided to include in the revised IAS 39 expanded guidance about how to determine fair values, in particular for financial instruments for which no quoted market price is available (Appendix A paragraphs AG74-AG82).† The Board decided that it is desirable to provide clear and reasonably detailed guidance about the objective and use of valuation techniques to achieve reliable and comparable fair value estimates when financial instruments are measured at fair value.

Use of quoted prices in active markets (paragraphs AG71-AG73)

BC96 The Board considered comments received that disagreed with the proposal in the Exposure Draft that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market. Some respondents argued that (a) valuation techniques are more appropriate for measuring fair value than a quoted price in an active market (eg for derivatives) and (b) valuation models are consistent with industry best practice, and are justified because of their acceptance for regulatory capital purposes.

BC97 However, the Board confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value as defined in the Standard does not depend on entity-specific factors. The Board further clarified that a quoted price includes market-quoted rates as well as prices.

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* IFRS 13, issued in May 2011, resulted in the relocation of paragraphs BC93 and BC94 of IAS 39 to paragraphs BCZ102 and BCZ103 of IFRS 13. As a consequence minor necessary edits have been made to that material.

\# IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

† IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence in Appendix A of IAS 39 paragraphs AG69-AG75, AG76A-AG79 and AG82 have been deleted and paragraphs AG76, AG80 and AG81 have been amended.

Entities that have access to more than one active market (paragraph AG71)

BC98 The Board considered situations in which entities operate in different markets. An example is a trader that originates a derivative with a corporate in an active corporate retail market and offsets the derivative by taking out a derivative with a dealer in an active dealers' wholesale market. The Board decided to clarify that the objective of fair value measurement is to arrive at the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market[*] to which an entity has immediate access. Thus, if a dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers' market, the entity recognises a profit on initial recognition of the derivative instrument. However, the entity adjusts the price observed in the dealer market for any differences in counterparty credit risk between the derivative instrument with the corporate and that with the dealers' market.

Bid-ask spreads in active markets (paragraph AG72)

BC99 The Board confirmed the proposal in the Exposure Draft that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price.[#] It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising up-front gains or losses for the difference between the bid-ask price and the mid-market price.

BC100 The Board discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.[†]

BC101 Comments received on the Exposure Draft revealed that some interpret the term 'bid-ask spread' differently from others and from the Board. Thus, IAS 39 clarifies that the spread represents only transaction costs.

No active market (paragraphs AG74-AG82)

BC102 The Exposure Draft proposed a three-tier fair value measurement hierarchy as follows:

(a) For instruments traded in active markets, use a quoted price.

(b) For instruments for which there is not an active market, use a recent market transaction.

(c) For instruments for which there is neither an active market nor a recent market transaction, use a valuation technique.

[*] IFRS 13, issued in May 2011, states that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market, or in the absence of a principal market, the most advantageous market for the asset or liability.

[#] IFRS 13, issued in May 2011, states that fair value is measured using the price within the bid-ask spread that is most representative of fair value in the circumstances.

[†] IFRS 13, issued in May 2011, permits an exception to the fair value measurement requirements when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or the credit risk of a particular counterparty, allowing the entity to measure the fair value of its financial instruments on the basis of the entity's net exposure to either of those risks.

BC103 The Board decided to simplify the proposed fair value measurement hierarchy[*] by requiring the fair value of financial instruments for which there is not an active market to be determined on the basis of valuation techniques, including the use of recent market transactions between knowledgeable, willing parties in an arm's length transaction.

BC104 The Board also considered constituents' comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising up-front gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value.[#] The Board also noted that its decision achieved convergence with US GAAP.[†]

Reclassification of financial instruments

BC104A As described in paragraph BC11E, in October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP. SFAS 115 permits a security to be reclassified out of the trading category in rare situations. SFAS 65 permits a loan to be reclassified out of the Held for Sale category if the entity has the intention and ability to hold the loan for the foreseeable future or until maturity. IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held-for-trading category as is permitted by SFAS 115 and SFAS 65.

BC104B The Board noted that allowing reclassification, even in limited circumstances, could allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets.

BC104C The Board was also informed that, in practice under US GAAP, reclassification out of the trading category of SFAS 115 is extremely rare. However, the Board noted that the possibility of reclassification of securities and loans under US GAAP is available and that entities applying IFRSs do not have that possibility.

BC104D The Board therefore decided to permit non-derivative financial assets to be reclassified out of the held-for-trading category in the same circumstances as are permitted in SFAS 115 and SFAS 65. The Board also noted that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term. In addition, the Board decided that a financial asset that would have met the definition of loans and receivables (if it had not been designated as available for sale) should be permitted to be transferred from the available-for-sale category to loans and receivables, if the entity intends to hold the loan or receivable for the foreseeable future or until maturity. The Board decided that this substantially aligns the accounting for reclassifications of loans and receivables with that permitted under US GAAP.

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[*] IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value.

[#] IFRS 13, issued in May 2011, describes when a transaction price might not represent the fair value of an asset or a liability at initial recognition.

[†] FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) superseded EITF Issue No. 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Involved in Energy Trading and Risk Management Activities* (Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*® codified SFAS 157). As a result, IFRSs and US GAAP have different requirements for when an entity may recognise a gain or loss when there is a difference between fair value and the transaction price at initial recognition.

BC104E The Board normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, given the requests to address this issue urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to proceed directly to issuing the amendments. In taking this exceptional step the Board noted that the amendments to IAS 39 relaxed the existing requirements to provide short-term relief for some entities. The Board also noted that the amendments were a short-term response to the requests and therefore the Board decided to restrict the scope of the amendments. Shortly afterwards, in response to representations from some interested parties, the Board issued a further amendment clarifying the effective date of the amendments to IAS 39.

Impairment and uncollectibility of financial assets

Impairment of investments in equity instruments (paragraph 61)

BC105 Under IAS 39, investments in equity instruments that are classified as available for sale and investments in unquoted equity instruments[*] whose fair value cannot be reliably measured are subject to an impairment assessment. The original IAS 39 did not include guidance about impairment indicators that are specific to investments in equity instruments. Questions were raised about when in practice such investments become impaired.

BC106 The Board agreed that for marketable investments in equity instruments any impairment trigger other than a decline in fair value below cost is likely to be arbitrary to some extent. If markets are reasonably efficient, today's market price is the best estimate of the discounted value of the future market price. However, the Board also concluded that it is important to provide guidance to address the questions raised in practice.

BC107 The revised IAS 39 includes impairment triggers that the Board concluded were reasonable in the case of investments in equity instruments (paragraph 61). They apply in addition to those specified in paragraph 59, which focus on the assessment of impairment in debt instruments.

Incurred versus expected losses

BC108 Some respondents to the Exposure Draft were confused about whether the Exposure Draft reflected an 'incurred loss' model or an 'expected loss' model. Others expressed concern about the extent to which 'future losses' could be recognised as impairment losses. They suggested that losses should be recognised only when they are incurred (ie a deterioration in the credit quality of an asset or a group of assets after their initial recognition). Other respondents favoured the use of an expected loss approach. They suggested that expected future losses should be considered in the determination of the impairment loss for a group of assets even if the credit quality of a group of assets has not deteriorated from original expectations.

BC109 In considering these comments, the Board decided that impairment losses should be recognised only if they have been incurred. The Board reasoned that it was inconsistent with an amortised cost model to recognise impairment on the basis of expected future transactions and events. The Board also decided that guidance should be provided about what 'incurred' means when assessing whether impairment exists in a group of financial assets. The Board was concerned that, in the absence of such guidance, there could be a range of interpretations about when a loss is incurred or what events cause a loss to be incurred in a group of assets.

BC110 Therefore, the Board included guidance in IAS 39 that specifies that for a loss to be incurred, an event that provides objective evidence of impairment must have occurred after the initial recognition of the financial asset, and IAS 39 now identifies types of such events. Possible or expected future trends that may lead to a loss in the future (eg an

[*] IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

expectation that unemployment will rise or a recession will occur) do not provide objective evidence of impairment. In addition, the loss event must have a reliably measurable effect on the present value of estimated future cash flows and be supported by current observable data.

Assets assessed individually and found not to be impaired (paragraphs 59(f) and 64)

BC111 It was not clear in the original IAS 39 whether loans and receivables and some other financial assets, when reviewed for impairment and determined not to be impaired, could or should subsequently be included in the assessment of impairment for a group of financial assets with similar characteristics.

BC112 The Exposure Draft proposed that a loan asset or other financial asset that is measured at amortised cost and has been individually assessed for impairment and found not to be impaired should be included in a collective assessment of impairment. The Exposure Draft also included proposed guidance about how to evaluate impairment inherent in a group of financial assets.

BC113 The comment letters received on the Exposure Draft indicated considerable support for the proposal to include in a collective evaluation of impairment an individually assessed financial asset that is found not to be impaired.

BC114 The Board noted the following arguments in favour of an additional portfolio assessment for individually assessed assets that are found not to be impaired.

(a) Impairment that cannot be identified with an individual loan may be identifiable on a portfolio basis. The *Framework*[*] states that for a large population of receivables, some degree of non-payment is normally regarded as probable. In that case, an expense representing the expected reduction in economic benefits is recognised (*Framework*, paragraph 85).[#] For example, a lender may have some concerns about identified loans with similar characteristics, but not have sufficient evidence to conclude that an impairment loss has occurred on any of those loans on the basis of an individual assessment. Experience may indicate that some of those loans are impaired even though an individual assessment may not reveal this. The amount of loss in a large population of items can be estimated on the basis of experience and other factors by weighting all possible outcomes by their associated probabilities.

(b) Some time may elapse between an event that affects the ability of a borrower to repay a loan and actual default of the borrower. For example, if the market forward price for wheat decreases by 10 per cent, experience may indicate that the estimated payments from borrowers that are wheat farmers will decrease by 1 per cent over a one-year period. When the forward price decreases, there may be no objective evidence that any individual wheat farmer will default on an individually significant loan. On a portfolio basis, however, the decrease in the forward price may provide objective evidence that the estimated future cash flows on loans to wheat farmers have decreased by 1 per cent over a one-year period.

(c) Under IAS 39, impairment of loans is measured on the basis of the present value of estimated future cash flows. Estimations of future cash flows may change because of economic factors affecting a group of loans, such as country and industry factors, even if there is no objective evidence of impairment of an

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

[#] now paragraph 4.40 of the *Conceptual Framework*

(d) The *Framework*, paragraph 94,[*] requires an expense to be recognised only if it can be measured reliably. The process of estimating impairment in a group of loans that have been individually assessed for impairment but found not to be impaired may involve a significant degree of subjectivity. There may be a wide range of reasonable estimates of impairment. In practice, the establishment of general loan loss provisions is sometimes viewed as more of an art than a science. This portfolio approach should be applied only if it is necessary on practical grounds and not to override an assessment made on an individual loan, which must provide a better determination of whether an allowance is necessary.

(e) IAS 39 requires impairment to be measured on a present value basis using the original effective interest rate. Mechanically, it may not be obvious how to do this for a group of loans with similar characteristics that have different effective interest rates. In addition, measurement of impairment in a group of loans based on the present value of estimated cash flows discounted using the original effective interest rate may result in double-counting of losses that were expected on a portfolio basis when the loans were originated because the lender included compensation for those losses in the contractual interest rate charged. As a result, a portfolio assessment of impairment may result in the recognition of a loss almost as soon as a loan is issued. (This question arises also in measuring impairment on a portfolio basis for loans that are not individually assessed for impairment under IAS 39.)

BC116 The Board was persuaded by the arguments in favour of a portfolio assessment for individually assessed assets that are found not to be impaired and decided to confirm that a loan or other financial asset measured at amortised cost that is individually assessed for impairment and found not to be impaired should be included in a group of similar financial assets that are assessed for impairment on a portfolio basis. This is to reflect that, in the light of the law of large numbers, impairment may be evident in a group of assets, but not yet meet the threshold for recognition when any individual asset in that group is assessed. The Board also confirmed that it is important to provide guidance about how to assess impairment on a portfolio basis to introduce discipline into a portfolio assessment. Such guidance promotes consistency in practice and comparability of information across entities. It should also mitigate concerns that collective assessments of impairment should not be used to conceal changes in asset values or as a cushion for potential future losses.

BC117 Some respondents expressed concerns about some of the detailed guidance proposed in the Exposure Draft, such as the guidance about adjusting the discount rate for expected losses. Many entities indicated that they do not have the data and systems necessary to implement the proposed approach. The Board decided to eliminate some of the detailed application guidance (eg whether to make an adjustment of the discount rate for originally expected losses and an illustration of the application of the guidance).

Assets that are assessed individually and found to be impaired (paragraph 64)

BC118 In making a portfolio assessment of impairment, one issue that arises is whether the collective assessment should include assets that have been individually evaluated and identified as impaired.

[*] now paragraph 4.49 of the *Conceptual Framework*

HKAS 39 IG
Revised July ~~2012~~2014

Guidance on Implementing
Hong Kong Accounting Standard 39

Financial Instruments:

Recognition and Measurement

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

F.1.4 Internal hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. Does IAS 39.73 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. IAS 39 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for intragroup hedging transactions, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in ~~IAS 27.24~~ paragraph B86 of IFRS 10 *Consolidated Financial Statements* require ~~that 'intragroup balances, transactions, income and expenses shall be eliminated in full'~~ a parent to 'eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows'.

On the other hand, an intragroup hedging transaction may be designated as a hedge in the individual or separate financial statements of a group entity, if the intragroup transaction is an external transaction from the perspective of the group entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarises the application of IAS 39 to internal hedging transactions.

- IAS 39 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.

- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.

- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.

- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.

- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the banking division of Entity A enters into an internal interest rate swap with the trading division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, IAS 39 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage foreign currency risk on a centralised basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. ~~IAS 27~~ IFRS 10 requires all internal transactions to be eliminated in consolidated financial statements. As stated in IAS 39.73, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on profit or loss or other comprehensive income if (a) the internal derivatives are used in the same type of hedge relationship (ie fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognised in other comprehensive income are reclassified from equity to profit or loss in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognised in profit or loss or in other comprehensive income will offset on consolidation resulting in the same profit or loss and other comprehensive income as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of comprehensive income and the consolidated statement of financial position, that would need to be eliminated. In addition, there is an effect on profit or loss and other comprehensive income if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on profit or loss and other comprehensive income for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognised in other comprehensive income are reclassified from equity to profit or loss in different periods (because the hedged items affect profit or loss in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IAS 39.72 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognised firm commitments. This is because an unrecognised firm commitment or forecast transaction does not qualify as a hedging instrument under IAS 39. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial

HKFRS 1 (Revised)
Revised ~~June 2012~~July 2014

Effective for annual periods beginning on or after 1 July 2009

Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

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

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Hong Kong Financial Reporting Standard 1 *First-time Adoption of Hong Kong Financial Reporting Standards* (HKFRS 1) is set out in paragraphs 1–40 and Appendices A–E ~~and G~~. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 1 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

IN1 The Hong Kong Institute of Certified Public Accountants (HKICPA) issued HKFRS 1 in October 2003. This HKFRS prescribes the accounting treatment that an entity shall apply when it adopts HKFRSs for the first time as the basis for preparing its financial statements and interim financial reports.

IN2 Subsequently, HKFRS 1 was amended many times to accommodate first-time adoption requirements resulting from new or amended HKFRSs. As a result, the HKFRS became more complex and less clear. Therefore, the HKICPA revised HKFRS 1 to make it easier for the reader to understand and to design it to better accommodate future changes. The version of HKFRS 1 issued in 2008 retains the substance of the previous version, but within a changed structure. It replaces the previous version and is effective for entities applying HKFRSs for the first time for annual periods beginning on or after 1 July 2009. Earlier application is permitted.

Main features of the HKFRS

IN3 The HKFRS applies when an entity adopts HKFRSs for the first time by an explicit and unreserved statement of compliance with HKFRSs.

IN4 In general, the HKFRS requires an entity to comply with each HKFRS effective at the end of its first HKFRS reporting period. In particular, the HKFRS requires an entity to do the following in the opening HKFRS statement of financial position that it prepares as a starting point for its accounting under HKFRSs:

(a) recognise all assets and liabilities whose recognition is required by HKFRSs;

(b) not recognise items as assets or liabilities if HKFRSs do not permit such recognition;

(c) reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under HKFRSs; and

(d) apply HKFRSs in measuring all recognised assets and liabilities.

IN5 The HKFRS grants limited exemptions from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The HKFRS also prohibits retrospective application of HKFRSs in some areas, particularly where retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known.

IN6 The HKFRS requires disclosures that explain how the transition from previous GAAP to HKFRSs affected the entity's reported financial position, financial performance and cash flows.

IN7 An entity is required to apply the HKFRS if its first HKFRS financial statements are for a period beginning on or after 1 July 2009. Earlier application is encouraged.

IN8 Paragraphs B10 and B11 (introduced by *Government Loans* in March 2012) refer to HKFRS 9. If an entity applies this HKFRS but does not yet apply HKFRS 9, the references in paragraphs B10 and B11 to HKFRS 9 shall be read as references to HKAS 39 *Financial Instruments: Recognition and Measurement*.

Hong Kong Financial Reporting Standard 1
First-time Adoption of Hong Kong Financial Reporting Standards

Objective

1 The objective of this HKFRS is to ensure that an entity's *first HKFRS financial statements*, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

(a) is transparent for users and comparable over all periods presented;

(b) provides a suitable starting point for accounting in accordance with *Hong Kong Financial Reporting Standards (HKFRSs)*; and

(c) can be generated at a cost that does not exceed the benefits.

Scope

2 An entity shall apply this HKFRS in:

(a) its first HKFRS financial statements; and

(b) each interim financial report, if any, that it presents in accordance with HKAS 34 *Interim Financial Reporting* for part of the period covered by its first HKFRS financial statements.

3 An entity's first HKFRS financial statements are the first annual financial statements in which the entity adopts HKFRSs, by an explicit and unreserved statement in those financial statements of compliance with HKFRSs. Financial statements in accordance with HKFRSs are an entity's first HKFRS financial statements if, for example, the entity:

(a) presented its most recent previous financial statements:

(i) in accordance with other accounting requirements that are not consistent with HKFRSs in all respects;

(ii) in conformity with HKFRSs in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with HKFRSs;

(iii) containing an explicit statement of compliance with some, but not all, HKFRSs;

(iv) in accordance with other accounting requirements inconsistent with HKFRSs, using some individual HKFRSs to account for items for which other accounting requirements did not exist; or

(v) in accordance with other accounting requirements, with a reconciliation of some amounts to the amounts determined in accordance with HKFRSs;

(b) prepared financial statements in accordance with HKFRSs for internal use only, without making them available to the entity's owners or any other external users;

(c) prepared a reporting package in accordance with HKFRSs for consolidation purposes without preparing a complete set of financial statements as defined in HKAS 1 *Presentation of Financial Statements* (as revised in 2007); or

(d) did not present financial statements for previous periods.

4 This HKFRS applies when an entity first adopts HKFRSs. It does not apply when, for example, an entity:

(a) stops presenting financial statements in accordance with other accounting requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with HKFRSs;

(b) presented financial statements in the previous year in accordance with other accounting requirements and those financial statements contained an explicit and unreserved statement of compliance with HKFRSs; or

(c) presented financial statements in the previous year that contained an explicit and unreserved statement of compliance with HKFRSs, even if the auditors qualified their audit report on those financial statements.

4A Notwithstanding the requirements in paragraphs 2 and 3, an entity that has applied HKFRSs in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with HKFRSs, must either apply this HKFRS or else apply HKFRSs retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as if the entity had never stopped applying HKFRSs.

4B When an entity does not elect to apply this HKFRS in accordance with paragraph 4A, the entity shall nevertheless apply the disclosure requirements in paragraphs 23A-23B of HKFRS 1, in addition to the disclosure requirements in HKAS 8.

5 This HKFRS does not apply to changes in accounting policies made by an entity that already applies HKFRSs. Such changes are the subject of:

(a) requirements on changes in accounting policies in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; and

(b) specific transitional requirements in other HKFRSs.

Recognition and measurement

Opening HKFRS statement of financial position

6 An entity shall prepare and present an *opening HKFRS statement of financial position* at the *date of transition to HKFRSs*. This is the starting point for its accounting in accordance with HKFRSs.

Accounting policies

7 An entity shall use the same accounting policies in its opening HKFRS statement of financial position and throughout all periods presented in its first HKFRS financial statements. Those accounting policies shall comply with each HKFRS effective at the end of its *first HKFRS reporting period*, except as specified in paragraphs 13–19 and Appendices B–E.

8 An entity shall not apply different versions of HKFRSs that were effective at earlier dates. An entity may apply a new HKFRS that is not yet mandatory if that HKFRS permits early application.

Example: Consistent application of latest version of HKFRSs

Background

The end of entity A's first HKFRS reporting period is 31 December 20X5. Entity A decides to present comparative information in those financial statements for one year only (see paragraph 21). Therefore, its date of transition to HKFRSs is the beginning of business on 1 January 20X4 (or, equivalently, close of business on 31 December 20X3). Entity A presented financial statements in accordance with its *previous GAAP* annually to 31 December each year up to, and including, 31 December 20X4.

Application of requirements

Entity A is required to apply the HKFRSs effective for periods ending on 31 December 20X5 in:

(a) preparing and presenting its opening HKFRS statement of financial position at 1 January 20X4; and

(b) preparing and presenting its statement of financial position for 31 December 20X5 (including comparative amounts for 20X4), statement of comprehensive income, statement of changes in equity and statement of cash flows for the year to 31 December 20X5 (including comparative amounts for 20X4) and disclosures (including comparative information for 20X4).

If a new HKFRS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that HKFRS in its first HKFRS financial statements.

9 The transitional provisions in other HKFRSs apply to changes in accounting policies made by an entity that already uses HKFRSs; they do not apply to a *first-time adopter*'s transition to HKFRSs, except as specified in Appendices B–E.

10 Except as described in paragraphs 13–19 and Appendices B–E, an entity shall, in its opening HKFRS statement of financial position:

(a) recognise all assets and liabilities whose recognition is required by HKFRSs;

(b) not recognise items as assets or liabilities if HKFRSs do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with HKFRSs; and

(d) apply HKFRSs in measuring all recognised assets and liabilities.

11 The accounting policies that an entity uses in its opening HKFRS statement of financial position may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to HKFRSs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to HKFRSs.

12 This HKFRS establishes two categories of exceptions to the principle that an entity's opening HKFRS statement of financial position shall comply with each HKFRS:

(a) paragraphs 14-17 and Appendix B prohibit retrospective application of some aspects of other HKFRSs.

(b) Appendices C–E grant exemptions from some requirements of other HKFRSs.

Exceptions to the retrospective application of other HKFRSs

13 This HKFRS prohibits retrospective application of some aspects of other HKFRSs. These exceptions are set out in paragraphs 14–17 and Appendix B.

Estimates

14 An entity's estimates in accordance with HKFRSs at the date of transition to HKFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

15 An entity may receive information after the date of transition to HKFRSs about estimates that it had made under previous GAAP. In accordance with paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with HKAS 10 *Events after the Reporting Period*. For example, assume that an entity's date of transition to HKFRSs is 1 January 20X4 and new information on 15 July 20X4 requires the revision of an estimate made in accordance with previous GAAP at 31 December 20X3. The entity shall not reflect that new information in its opening HKFRS statement of financial position (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 December 20X4.

16 An entity may need to make estimates in accordance with HKFRSs at the date of transition to HKFRSs that were not required at that date under previous GAAP. To achieve consistency with HKAS 10, those estimates in accordance with HKFRSs shall reflect conditions that existed at the date of transition to HKFRSs. In particular, estimates at the date of transition to HKFRSs of market prices, interest rates or foreign exchange rates shall reflect market conditions at that date.

17 Paragraphs 14–16 apply to the opening HKFRS statement of financial position. They also apply to a comparative period presented in an entity's first HKFRS financial statements, in which case the references to the date of transition to HKFRSs are replaced by references to the end of that comparative period.

Exemptions from other HKFRSs

18 An entity may elect to use one or more of the exemptions contained in Appendices C–E. An entity shall not apply these exemptions by analogy to other items.

19 [Deleted]~~Some exemptions in Appendices C–E refer to *fair value*. In determining fair values in accordance with this HKFRS, an entity shall apply the definition of fair value in Appendix A and any more specific guidance in other HKFRSs on the determination of fair values for the asset or liability in question. Those fair values shall reflect conditions that existed at the date for which they were determined.~~

Presentation and disclosure

20 This HKFRS does not provide exemptions from the presentation and disclosure requirements in other HKFRSs.

Comparative information

21 ~~To comply with HKAS 1, an~~ An entity's first HKFRS financial statements shall include at least three statements of financial position, two statements of profit or loss and other comprehensive income, two separate ~~income~~ statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information for all statements presented.

Non-HKFRS comparative information and historical summaries

22 Some entities present historical summaries of selected data for periods before the first period for which they present full comparative information in accordance with HKFRSs. This HKFRS does not require such summaries to comply with the recognition and measurement requirements of HKFRSs. Furthermore, some entities present comparative information in accordance with previous GAAP as well as the comparative information required by HKAS 1. In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:

(a) label the previous GAAP information prominently as not being prepared in accordance with HKFRSs; and

(b) disclose the nature of the main adjustments that would make it comply with HKFRSs. An entity need not quantify those adjustments.

Explanation of transition to HKFRSs

23 An entity shall explain how the transition from previous GAAP to HKFRSs affected its reported financial position, financial performance and cash flows.

23A An entity that has applied HKFRSs in a previous period, as described in paragraph 4A, shall disclose:

(a) the reason it stopped applying HKFRSs; and

(b) the reason it is resuming the application of HKFRSs.

23B When an entity, in accordance with paragraph 4A, does not elect to apply HKFRS 1, the entity shall explain the reasons for electing to apply HKFRSs as if it had never stopped applying HKFRSs.

Reconciliations

24 To comply with paragraph 23, an entity's first HKFRS financial statements shall include:

(a) reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with HKFRSs for both of the following dates:

(i) the date of transition to HKFRSs; and

(ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.

(b) a reconciliation to its total comprehensive income in accordance with HKFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

(c) if the entity recognised or reversed any impairment losses for the first time in preparing its opening HKFRS statement of financial position, the disclosures that HKAS 36 *Impairment of Assets* would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to HKFRSs.

25 The reconciliations required by paragraph 24(a) and (b) shall give sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. If an entity presented a statement of cash flows under its previous GAAP, it shall also explain the material adjustments to the statement of cash flows.

26 If an entity becomes aware of errors made under previous GAAP, the reconciliations required by paragraph 24(a) and (b) shall distinguish the correction of those errors from changes in accounting policies.

27 HKAS 8 does not apply to the changes in accounting policies an entity makes when it adopts HKFRSs or to changes in those policies until after it presents its first HKFRS financial statements. Therefore, HKAS 8's requirements about changes in accounting policies do not apply in an entity's first HKFRS financial statements.

27A If during the period covered by its first HKFRS financial statements an entity changes its accounting policies or its use of the exemptions contained in this HKFRS, it shall explain the changes between its first HKFRS interim financial report and its first HKFRS financial statements, in accordance with paragraph 23, and it shall update the reconciliations required by paragraph 24(a) and (b).

28 If an entity did not present financial statements for previous periods, its first HKFRS financial statements shall disclose that fact.

Designation of financial assets or financial liabilities

29 An entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or a financial asset as available for sale in accordance with paragraph D19. The entity shall disclose the fair value of financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

Use of fair value as deemed cost

30 If an entity uses fair value in its opening HKFRS statement of financial position as *deemed cost* for an item of property, plant and equipment, an investment property or an intangible asset (see paragraphs D5 and D7), the entity's first HKFRS financial statements shall disclose, for each line item in the opening HKFRS statement of financial position:

(a) the aggregate of those fair values; and

(b) the aggregate adjustment to the carrying amounts reported under previous GAAP.

Use of deemed cost for investments in subsidiaries, joint~~ly~~ ventures~~controlled entities~~ and associates

31 Similarly, if an entity uses a deemed cost in its opening HKFRS statement of financial position for an investment in a subsidiary, ~~jointly controlled entity~~ joint venture or associate in its separate financial statements (see paragraph D15), the entity's first HKFRS separate financial statements shall disclose:

(a) the aggregate deemed cost of those investments for which deemed cost is their previous GAAP carrying amount;

(b) the aggregate deemed cost of those investments for which deemed cost is fair value; and

(c) the aggregate adjustment to the carrying amounts reported under previous GAAP.

Use of deemed cost for oil and gas assets

31A If an entity uses the exemption in paragraph D8A(b) for oil and gas assets, it shall disclose that fact and the basis on which carrying amounts determined under previous GAAP were allocated.

Use of deemed cost for operations subject to rate regulation

31B If an entity uses the exemption in paragraph D8B for operations subject to rate regulation, it shall disclose that fact and the basis on which carrying amounts were determined under previous GAAP.

Use of deemed cost after severe hyperinflation

31C If an entity elects to measure assets and liabilities at fair value and to use that fair value as the deemed cost in its opening HKFRS statement of financial position because of severe hyperinflation (see paragraphs D26–D30), the entity's first HKFRS financial statements shall disclose an explanation of how, and why, the entity had, and then ceased to have, a functional currency that has both of the following characteristics:

(a) a reliable general price index is not available to all entities with transactions and balances in the currency.

(b) exchangeability between the currency and a relatively stable foreign currency does not exist.

Interim financial reports

32 To comply with paragraph 23, if an entity presents an interim financial report in accordance with HKAS 34 for part of the period covered by its first HKFRS financial statements, the entity shall satisfy the following requirements in addition to the requirements of HKAS 34:

(a) Each such interim financial report shall, if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, include:

(i) a reconciliation of its equity in accordance with previous GAAP at the end of that comparable interim period to its equity under HKFRSs at that date; and

(ii) a reconciliation to its total comprehensive income in accordance with HKFRSs for that comparable interim period (current and year to date). The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for that period or, if an entity did not report such a total, profit or loss in accordance with previous GAAP.

(b) In addition to the reconciliations required by (a), an entity's first interim financial report in accordance with HKAS 34 for part of the period covered by its first HKFRS financial statements shall include the reconciliations described in paragraph 24(a) and (b) (supplemented by the details required by paragraphs 25 and 26) or a cross-reference to another published document that includes these reconciliations.

(c) If an entity changes its accounting policies or its use of the exemptions contained in this HKFRS, it shall explain the changes in each such interim financial report in accordance with paragraph 23 and update the reconciliations required by (a) and (b).

33 HKAS 34 requires minimum disclosures, which are based on the assumption that users of the interim financial report also have access to the most recent annual financial statements. However, HKAS 34 also requires an entity to disclose 'any events or transactions that are material to an understanding of the current interim period'. Therefore, if a first-time adopter did not, in its most recent annual financial statements in accordance with previous GAAP, disclose information material to an understanding of the current interim period, its interim financial report shall disclose that information or include a cross-reference to another published document that includes it.

Effective date

34 An entity shall apply this HKFRS if its first HKFRS financial statements are for a period beginning on or after 1 July 2009. Earlier application is permitted.

35 An entity shall apply the amendments in paragraphs D1(n) and D23 for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 23 *Borrowing Costs* (as revised in 2007) for an earlier period, those amendments shall be applied for that earlier period.

36 HKFRS 3 *Business Combinations* (as revised in 2008) amended paragraphs 19, C1 and C4(f) and (g). If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.

37 HKAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) amended paragraphs B1 and B7. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period.

38 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 and HKAS 27), issued in October 2008, added paragraphs 31, D1(g), D14 and D15. An entity shall apply those paragraphs for annual periods beginning on or after 1 July 2009. Earlier application is permitted. If an entity applies the paragraphs for an earlier period, it shall disclose that fact.

39 Paragraph B7 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period.

39a An entity shall apply paragraphs B2 to B6 and D18 for annual periods beginning on or after 1 January 2005. Earlier application of those paragraphs is encouraged.

39A *Additional Exemptions for First-time Adopters* (Amendments to HKFRS 1), issued in August 2009, added paragraphs 31A, D8A, D9A and D21A and amended paragraph D1(c), (d) and (l). An entity shall apply those amendments for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

39B *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

39C HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments* added paragraph D25. An entity shall apply that amendment when it applies HK(IFRIC)-Int 19.

39D *Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters* (Amendment to HKFRS 1), issued in February 2010, added paragraph E3. An entity shall apply that amendment for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

39E *Improvements to HKFRSs* issued in May 2010 added paragraphs 27A, 31B and D8B and amended paragraphs 27, 32, D1(c) and D8. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Entities that adopted HKFRSs in periods before the effective date of HKFRS 1 or applied HKFRS 1 in a previous period are permitted to apply the amendment to paragraph D8 retrospectively in the first annual period after the amendment is effective. An entity applying paragraph D8 retrospectively shall disclose that fact.

39F *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7), issued in October 2010, added paragraph E4. An entity shall apply that amendment for annual periods beginning on or after 1 July 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

39G *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

39H *Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters* (Amendments to HKFRS 1), issued in December 2010, amended paragraphs B2, D1 and D20 and added paragraphs 31C and D26–D30. An entity shall apply those amendments for annual periods beginning on or after 1 July 2011. Earlier application is permitted.

39I HKFRS 10 *Consolidated Financial Statements* and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 31, B7, C1, D1, D14 and D15 and added paragraph D31. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.

39J HKFRS 13 *Fair Value Measurement*, issued in June 2011, deleted paragraph 19, amended the definition of fair value in Appendix A and amended paragraphs D15 and D20. An entity shall apply those amendments when it applies HKFRS 13.

39K *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 21. An entity shall apply that amendment when it applies HKAS 1 as amended in July 2011.

39L HKAS 19 *Employee Benefits* (as amended in July 2011) amended paragraph D1, deleted paragraphs D10 and D11 and added paragraph E5. An entity shall apply those amendments when it applies HKAS 19 (as amended in July 2011).

39M HK(IFRIC)-Int 20 *Stripping Costs in the Production Phase of a Surface Mine* added paragraph D32 and amended paragraph D1. An entity shall apply that amendment when it applies HK(IFRIC)-Int 20.

39N *Government Loans* (Amendments to HKFRS 1), issued in March 2012, added paragraphs B1(f) and B10–B12. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

39O Paragraphs B10 and B11 refer to HKFRS 9. If an entity applies this HKFRS but does not yet apply HKFRS 9, the references in paragraphs B10 and B11 to HKFRS 9 shall be read as references to HKAS 39 *Financial Instruments: Recognition and Measurement*.

39P *Annual Improvements 2009–2011 Cycle*, issued in June 2012, added paragraphs 4A–4B and 23A–23B. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

39Q *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraph D23. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

39R *Annual Improvements 2009–2011 Cycle*, issued in June 2012, amended paragraph 21. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

39S *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to HKFRS 10, HKFRS 11 and HKFRS 12), issued in July 2012, amended paragraph D31. An entity shall apply that amendment when it applies HKFRS 11 (as amended in July 2012).

Withdrawal of HKFRS 1 (issued 2003)

40 This HKFRS supersedes HKFRS 1 (issued in 2003 and amended at December 2008).

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

date of transition to HKFRSs	The beginning of the earliest period for which an entity presents full comparative information under HKFRSs in its **first HKFRS financial statements**.
deemed cost	An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.
fair value	~~The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.~~*Fair Value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13.)
first HKFRS financial statements	The first annual financial statements in which an entity adopts **Hong Kong Financial Reporting Standards (HKFRSs)**, by an explicit and unreserved statement of compliance with HKFRSs.
first HKFRS reporting period	The latest reporting period covered by an entity's **first HKFRS financial statements.**
first-time adopter	An entity that presents its **first HKFRS financial statements**.
Hong Kong Financial Reporting Standards (HKFRSs)	Standards and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). They comprise: (a) Hong Kong Financial Reporting Standards; (b) Hong Kong Accounting Standards; and (c) Interpretations.
opening HKFRS statement of financial position	An entity's statement of financial position at the **date of transition to HKFRSs**.
previous GAAP	The basis of accounting that a **first-time adopter** used immediately before adopting HKFRSs.

Appendix B
Exceptions to the retrospective application of other HKFRSs

This appendix is an integral part of the HKFRS.

B1 An entity shall apply the following exceptions:

(a) derecognition of financial assets and financial liabilities (paragraphs B2 and B3);

(b) hedge accounting (paragraphs B4–B6); ~~and~~

(c) non-controlling interests (paragraph B7)~~.~~;

(d) *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

(e) *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

(f) government loans (paragraphs B10 – B12).

Derecognition of financial assets and financial liabilities

B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in HKAS 39 *Financial Instruments: Recognition and Measurement* prospectively for transactions occurring on or after the date of transition to HKFRSs. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to HKFRSs, it shall not recognise those assets and liabilities in accordance with HKFRSs (unless they qualify for recognition as a result of a later transaction or event).

B3 Notwithstanding paragraph B2, an entity may apply the derecognition requirements in HKAS 39 retrospectively from a date of the entity's choosing, provided that the information needed to apply HKAS 39 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge accounting

B4 As required by HKAS 39, at the date of transition to HKFRSs, an entity shall:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

B5 An entity shall not reflect in its opening HKFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with HKAS 39 (for example, many hedging relationships where the hedging instrument is a cash instrument or written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with HKFRSs, provided that it does so no later than the date of transition to HKFRSs.

B6 If, before the date of transition to HKFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in HKAS 39, the entity shall apply paragraphs 91 and 101 of HKAS 39 to discontinue hedge accounting. Transactions entered into before the date of transition to HKFRSs shall not be retrospectively designated as hedges.

Non-controlling interests

B7 A first-time adopter shall apply the following requirements of HKFRS 10~~HKAS 27 (as amended in 2008)~~ prospectively from the date of transition to HKFRSs:

(a) the requirement in paragraph ~~28~~ B94 that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

(b) the requirements in paragraphs ~~30 and 31~~ 23 and B93 for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

(c) the requirements in paragraphs ~~34–37~~ B97 – B99 for accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

However, if a first-time adopter elects to apply HKFRS 3 ~~(as revised in 2008)~~ retrospectively to past business combinations, it shall also apply ~~HKAS 27 (as amended in 2008)~~ HKFRS 10 in accordance with paragraph C1 of this HKFRS.

B8 *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

B9 *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

Government loans

B10 A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with HKAS 32 *Financial Instruments: Presentation*. Except as permitted by paragraph B11, a first-time adopter shall apply the requirements in HKFRS 9 *Financial Instruments* and HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* prospectively to government loans existing at the date of transition to HKFRSs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with HKFRS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to HKFRSs as the carrying amount of the loan in the opening HKFRS statement of financial position. An entity shall apply HKFRS 9 to the measurement of such loans after the date of transition to HKFRSs.

B11 Despite paragraph B10, an entity may apply the requirements in HKFRS 9 and HKAS 20 retrospectively to any government loan originated before the date of transition to HKFRSs, provided that the information needed to do so had been obtained at the time of initially accounting for that loan.

B12 The requirements and guidance in paragraphs B10 and B11 do not preclude an entity from being able to use the exemptions described in paragraphs D19–D19D relating to the designation of previously recognised financial instruments at fair value through profit or loss.

Appendix C
Exemptions for business combinations

This appendix is an integral part of the HKFRS. An entity shall apply the following requirements to business combinations that the entity recognised before the date of transition to HKFRSs. This Appendix should only be applied to business combinations within the scope of HKFRS 3 Business Combinations*.*

C1 A first-time adopter may elect not to apply HKFRS 3 ~~(as amended in 2008)~~ retrospectively to past business combinations (business combinations that occurred before the date of transition to HKFRSs). However, if a first-time adopter restates any business combination to comply with HKFRS 3 ~~(as amended in 2008)~~, it shall restate all later business combinations and shall also apply ~~HKAS 27 (as amended in 2008)~~HKFRS 10 from that same date. For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X6, it shall restate all business combinations that occurred between 30 June 20X6 and the date of transition to HKFRSs, and it shall also apply ~~HKAS 27 (amended 2008)~~ HKFRS 10 from 30 June 20X6.

C2 An entity need not apply HKAS 21 *The Effects of Changes in Foreign Exchange Rates* retrospectively to fair value adjustments and goodwill arising in business combinations that occurred before the date of transition to HKFRSs. If the entity does not apply HKAS 21 retrospectively to those fair value adjustments and goodwill, it shall treat them as assets and liabilities of the entity rather than as assets and liabilities of the acquiree. Therefore, those goodwill and fair value adjustments either are already expressed in the entity's functional currency or are non-monetary foreign currency items, which are reported using the exchange rate applied in accordance with previous GAAP.

C3 An entity may apply HKAS 21 retrospectively to fair value adjustments and goodwill arising in either:

(a) all business combinations that occurred before the date of transition to HKFRSs; or

(b) all business combinations that the entity elects to restate to comply with HKFRS 3, as permitted by paragraph C1 above.

C4 If a first-time adopter does not apply HKFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:

(a) The first-time adopter shall keep the same classification (as an acquisition by the legal acquirer, a reverse acquisition by the legal acquiree, or a uniting of interests) as in its previous GAAP financial statements.

(b) The first-time adopter shall recognise all its assets and liabilities at the date of transition to HKFRSs that were acquired or assumed in a past business combination, other than:

(i) some financial assets and financial liabilities derecognised in accordance with previous GAAP (see paragraph B2); and

(ii) assets, including goodwill, and liabilities that were not recognised in the acquirer's consolidated statement of financial position in accordance with previous GAAP and also would not qualify for recognition in accordance with HKFRSs in the separate statement of financial position of the acquiree (see (f)–(i) below).

The first-time adopter shall recognise any resulting change by adjusting retained earnings (or, if appropriate, another category of equity), unless the change results from the recognition of an intangible asset that was previously subsumed within goodwill (see (g)(i) below).

(c) The first-time adopter shall exclude from its opening HKFRS statement of financial position any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under HKFRSs. The first-time adopter shall account for the resulting change as follows:

(i) the first-time adopter may have classified a past business combination as an acquisition and recognised as an intangible asset an item that does not qualify for recognition as an asset in accordance with HKAS 38 *Intangible Assets*. It shall reclassify that item (and, if any, the related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill directly from equity in accordance with previous GAAP, see (g)(i) and (i) below).

(ii) the first-time adopter shall recognise all other resulting changes in retained earnings.[*]

(d) HKFRSs require subsequent measurement of some assets and liabilities on a basis that is not based on original cost, such as fair value. The first-time adopter shall measure these assets and liabilities on that basis in its opening HKFRS statement of financial position, even if they were acquired or assumed in a past business combination. It shall recognise any resulting change in the carrying amount by adjusting retained earnings (or, if appropriate, another category of equity), rather than goodwill.

(e) Immediately after the business combination, the carrying amount in accordance with previous GAAP of assets acquired and liabilities assumed in that business combination shall be their deemed cost in accordance with HKFRSs at that date. If HKFRSs require a cost-based measurement of those assets and liabilities at a later date, that deemed cost shall be the basis for cost-based depreciation or amortisation from the date of the business combination.

(f) If an asset acquired, or liability assumed, in a past business combination was not recognised in accordance with previous GAAP, it does not have a deemed cost of zero in the opening HKFRS statement of financial position. Instead, the acquirer shall recognise and measure it in its consolidated statement of financial position on the basis that HKFRSs would require in the statement of financial position of the acquiree. To illustrate: if the acquirer had not, in accordance with its previous GAAP, capitalised finance leases acquired in a past business combination, it shall capitalise those leases in its consolidated financial statements, as HKAS 17 *Leases* would require the acquiree to do in its HKFRS statement of financial position. Similarly, if the acquirer had not, in accordance with its previous GAAP, recognised a contingent liability that still exists at the date of transition to HKFRSs, the acquirer shall recognise that contingent liability at that date unless HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would prohibit its recognition in the financial statements of the acquiree. Conversely, if an asset or liability was subsumed in goodwill in accordance with previous GAAP but would have been recognised separately under HKFRS 3, that asset or liability remains in goodwill unless HKFRSs would require its recognition in the financial statements of the acquiree.

(g) The carrying amount of goodwill in the opening HKFRS statement of financial position shall be its carrying amount in accordance with previous GAAP at the date of transition to HKFRSs, after the following two adjustments:

(i) If required by (c)(i) above, the first-time adopter shall increase the carrying amount of goodwill when it reclassifies an item that it recognised as an intangible asset in accordance with previous GAAP. Similarly, if (f) above requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill in accordance with previous GAAP, the first-time adopter

[*] Such changes include reclassifications from or to intangible assets if goodwill was not recognised in accordance with previous GAAP as an asset. This arises if, in accordance with previous GAAP, the entity (a) deducted goodwill directly from equity or (b) did not treat the business combination as an acquisition.

shall decrease the carrying amount of goodwill accordingly (and, if applicable, adjust deferred tax and non-controlling interests).

(ii) Regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply HKAS 36 in testing the goodwill for impairment at the date of transition to HKFRSs and in recognising any resulting impairment loss in retained earnings (or, if so required by HKAS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to HKFRSs.

(h) No other adjustments shall be made to the carrying amount of goodwill at the date of transition to HKFRSs. For example, the first-time adopter shall not restate the carrying amount of goodwill:

(i) to exclude in-process research and development acquired in that business combination (unless the related intangible asset would qualify for recognition in accordance with HKAS 38 in the statement of financial position of the acquiree);

(ii) to adjust previous amortisation of goodwill;

(iii) to reverse adjustments to goodwill that HKFRS 3 would not permit, but were made in accordance with previous GAAP because of adjustments to assets and liabilities between the date of the business combination and the date of transition to HKFRSs.

(i) If the first-time adopter recognised goodwill in accordance with previous GAAP as a deduction from equity:

(i) it shall not recognise that goodwill in its opening HKFRS statement of financial position. Furthermore, it shall not reclassify that goodwill to profit or loss if it disposes of the subsidiary or if the investment in the subsidiary becomes impaired.

(ii) adjustments resulting from the subsequent resolution of a contingency affecting the purchase consideration shall be recognised in retained earnings.

(j) In accordance with its previous GAAP, the first-time adopter may not have consolidated a subsidiary acquired in a past business combination (for example, because the parent did not regard it as a subsidiary in accordance with previous GAAP or did not prepare consolidated financial statements). The first-time adopter shall adjust the carrying amounts of the subsidiary's assets and liabilities to the amounts that HKFRSs would require in the subsidiary's statement of financial position. The deemed cost of goodwill equals the difference at the date of transition to HKFRSs between:

(i) the parent's interest in those adjusted carrying amounts; and

(ii) the cost in the parent's separate financial statements of its investment in the subsidiary.

(k) The measurement of non-controlling interests and deferred tax follows from the measurement of other assets and liabilities. Therefore, the above adjustments to recognised assets and liabilities affect non-controlling interests and deferred tax.

C5 The exemption for past business combinations also applies to past acquisitions of investments in associates and of interests in joint ventures. Furthermore, the date selected for paragraph C1 applies equally for all such acquisitions.

Appendix D
Exemptions from other HKFRSs

This appendix is an integral part of the HKFRS.

D1 An entity may elect to use one or more of the following exemptions:

(a) share-based payment transactions (paragraphs D2 and D3);

(b) insurance contracts (paragraph D4);

(c) deemed cost (paragraphs D5–D8B);

(d) leases (paragraphs D9 and D9A);

(e) [deleted]~~employee benefits (paragraphs D10 and D11);~~

(f) cumulative translation differences (paragraphs D12 and D13);

(g) investments in subsidiaries, ~~jointly controlled entities~~ joint ventures and associates (paragraphs D14 and D15);

(h) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs D16 and D17);

(i) compound financial instruments (paragraph D18);

(j) designation of previously recognised financial instruments (paragraph D19);

(k) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph D20);

(l) decommissioning liabilities included in the cost of property, plant and equipment (paragraphs D21 and D21A);

(m) financial assets or intangible assets accounted for in accordance with HK(IFRIC)-Int 12 *Service Concession Arrangements* (paragraph D22);

(n) borrowing costs (paragraph D23);

(o) transfers of assets from customers (paragraph D24);

(p) extinguishing financial liabilities with equity instruments (paragraph D25); ~~and~~

(q) severe hyperinflation (paragraphs D26–D30)~~.~~;

(r) joint arrangements (paragraph D31); and

(s) stripping costs in the production phase of a surface mine (paragraph D32).

~~An entity shall not apply these exemptions by analogy to other items.~~

Share-based payment transactions

D2 A first-time adopter is encouraged, but not required, to apply HKFRS 2 *Share-based Payment* to equity instruments that were granted on or before 7 November 2002. A first-time adopter is also encouraged, but not required, to apply HKFRS 2 to equity instruments that were granted after 7 November 2002 and vested before the later of (a) the date of transition to HKFRSs and (b) 1 January 2005. However, if a first-time adopter elects to apply HKFRS 2 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in HKFRS 2. For all grants of equity instruments to which HKFRS 2 has not been applied (eg equity instruments granted on or before 7 November 2002), a first-time adopter shall nevertheless disclose the information required by paragraphs 44 and 45 of HKFRS 2. If a first-time adopter modifies the terms or conditions of a grant of equity instruments to which HKFRS 2 has not been applied, the entity is not required to apply paragraphs 26–29 of HKFRS 2 if the modification occurred before the date of transition to HKFRSs.

D3 A first-time adopter is encouraged, but not required, to apply HKFRS 2 to liabilities arising from share-based payment transactions that were settled before the date of transition to HKFRSs. A first-time adopter is also encouraged, but not required, to apply HKFRS 2 to liabilities that were settled before 1 January 2005. For liabilities to which HKFRS 2 is applied, a first-time adopter is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.

Insurance contracts

D4 A first-time adopter may apply the transitional provisions in HKFRS 4 *Insurance Contracts*. HKFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter.

Deemed cost

D5 An entity may elect to measure an item of property, plant and equipment at the date of transition to HKFRSs at its fair value and use that fair value as its deemed cost at that date.

D6 A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to HKFRSs as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

(a) fair value; or

(b) cost or depreciated cost in accordance with HKFRSs, adjusted to reflect, for example, changes in a general or specific price index.

D7 The elections in paragraphs D5 and D6 are also available for:

(a) investment property, if an entity elects to use the cost model in HKAS 40 *Investment Property,* and

(b) intangible assets that meet:

(i) the recognition criteria in HKAS 38 (including reliable measurement of original cost); and

(ii) the criteria in HKAS 38 for revaluation (including the existence of an active market).

An entity shall not use these elections for other assets or for liabilities.

D8 A first-time adopter may have established a deemed cost in accordance with previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering.

(a) If the measurement date is *at or before* the date of transition to HKFRSs, the entity may use such event-driven fair value measurements as deemed cost for HKFRSs at the date of that measurement.

(b) If the measurement date is *after* the date of transition to HKFRSs, but during the period covered by the first HKFRS financial statements, the event-driven fair value measurements may be used as deemed cost when the event occurs. An entity shall recognise the resulting adjustments directly in retained earnings (or if appropriate, another category of equity) at the measurement date. At the date of transition to HKFRSs, the entity shall either establish the deemed cost by applying the criteria in paragraphs D5–D7 or measure assets and liabilities in accordance with the other requirements in this HKFRS.

D8A Under some other accounting requirements exploration and development costs for oil and gas properties in the development or production phases are accounted for in cost centres that include all properties in a large geographical area. A first-time adopter using such accounting under previous GAAP may elect to measure oil and gas assets at the date of transition to HKFRSs on the following basis:

(a) exploration and evaluation assets at the amount determined under the entity's previous GAAP; and

(b) assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. The entity shall allocate this amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date.

The entity shall test exploration and evaluation assets and assets in the development and production phases for impairment at the date of transition to HKFRSs in accordance with HKFRS 6 *Exploration for and Evaluation of Mineral Resources* or HKAS 36 respectively and, if necessary, reduce the amount determined in accordance with (a) or (b) above. For the purposes of this paragraph, oil and gas assets comprise only those assets used in the exploration, evaluation, development or production of oil and gas.

D8B Some entities hold items of property, plant and equipment or intangible assets that are used, or were previously used, in operations subject to rate regulation. The carrying amount of such items might include amounts that were determined under previous GAAP but do not qualify for capitalisation in accordance with HKFRSs. If this is the case, a first-time adopter may elect to use the previous GAAP carrying amount of such an item at the date of transition to HKFRSs as deemed cost. If an entity applies this exemption to an item, it need not apply it to all items. At the date of transition to HKFRSs, an entity shall test for impairment in accordance with HKAS 36 each item for which this exemption is used. For the purposes of this paragraph, operations are subject to rate regulation if they provide goods or services to customers at prices (ie rates) established by an authorised body empowered to establish rates that bind the customers and that are designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. The specified return could be a minimum or range and need not be a fixed or guaranteed return.

Leases

D9 A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*. Therefore, a first-time adopter may determine whether an arrangement existing at the date of transition to HKFRSs contains a lease on the basis of facts and circumstances existing at that date.

D9A If a first-time adopter made the same determination of whether an arrangement contained a lease in accordance with previous GAAP as that required by HK(IFRIC)-Int 4 but at a date other than that required by HK(IFRIC)-Int 4, the first-time adopter need not reassess that determination when it adopts HKFRSs. For an entity to have made the same determination of whether the arrangement contained a lease in accordance with previous GAAP, that determination would have to have given the same outcome as that resulting from applying HKAS 17 *Leases* and HK(IFRIC)-Int 4.

~~Employee benefits~~

D10 [Deleted]~~In accordance with HKAS 19 *Employee Benefits*, an entity may elect to use a 'corridor' approach that leaves some actuarial gains and losses unrecognised. Retrospective application of this approach requires an entity to split the cumulative actuarial gains and losses from the inception of the plan until the date of transition to HKFRSs into a recognised portion and an unrecognised portion. However, a first-time adopter may elect to recognise all cumulative actuarial gains and losses at the date of transition to HKFRSs, even if it uses the corridor approach for later actuarial gains and losses. If a first-time adopter uses this election, it shall apply it to all plans.~~

D11 [Deleted]~~An entity may disclose the amounts required by paragraph 120A(p) of HKAS 19 as the amounts are determined for each accounting period prospectively from the date of transition to HKFRSs.~~

Cumulative translation differences

D12 HKAS 21 requires an entity:

(a) to recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity; and

(b) on disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation (including, if applicable, gains and losses on related hedges) from equity to profit or loss as part of the gain or loss on disposal.

D13 However, a first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to HKFRSs. If a first-time adopter uses this exemption:

(a) the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to HKFRSs; and

(b) the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to HKFRSs and shall include later translation differences.

Investments in subsidiaries, ~~jointly controlled entities~~ joint ventures and associates

D14 When an entity prepares separate financial statements, HKAS 27 (as amended in 2008) requires it to account for its investments in subsidiaries, jointly controlled entities and associates either:

(a) at cost; or

(b) in accordance with HKAS 39.

D15 If a first-time adopter measures such an investment at cost in accordance with HKAS 27, it shall measure that investment at one of the following amounts in its separate opening HKFRS statement of financial position:

(a) cost determined in accordance with HKAS 27; or

(b) deemed cost. The deemed cost of such an investment shall be its:

(i) fair value (determined in accordance with HKAS 39) at the entity's date of transition to HKFRSs in its separate financial statements; or

(ii) previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, ~~jointly controlled entity~~ joint venture or associate that it elects to measure using a deemed cost.

Assets and liabilities of subsidiaries, associates and joint ventures

D16 If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:

(a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to HKFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary; or

(b) the carrying amounts required by the rest of this HKFRS, based on the subsidiary's date of transition to HKFRSs. These carrying amounts could differ from those described in (a):

(i) when the exemptions in this HKFRS result in measurements that depend on the date of transition to HKFRSs.

(ii) when the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in HKAS 16 *Property, Plant and Equipment*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

D17 However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

Compound financial instruments

D18 HKAS 32 *Financial Instruments: Presentation* requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of HKAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, in accordance with this HKFRS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to HKFRSs.

Designation of previously recognised financial instruments

D19 HKAS 39 permits a financial asset to be designated on initial recognition as available for sale or a financial instrument (provided it meets certain criteria) to be designated as a financial asset or financial liability at fair value through profit or loss. Despite this requirement exceptions apply in the following circumstances:

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

(b) an entity is permitted to designate, at the date of transition to HKFRSs, any financial asset or financial liability as at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A of HKAS 39 at that date.

Fair value measurement of financial assets or financial liabilities at initial recognition

D20 Notwithstanding the requirements of paragraphs 7 and 9, an entity may apply the requirements in ~~the last sentence~~ paragraph AG76(a) of HKAS 39 ~~paragraph AG76 and in paragraph AG76A~~ prospectively to transactions entered into on or after the date of transition to HKFRSs.

Decommissioning liabilities included in the cost of property, plant and equipment

D21 HK(IFRIC)-Int 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. A first-time adopter need not comply with these requirements for changes in such liabilities that occurred before the date of transition to HKFRSs. If a first-time adopter uses this exemption, it shall:

(a) measure the liability as at the date of transition to HKFRSs in accordance with HKAS 37;

(b) to the extent that the liability is within the scope of HK(IFRIC)-Int 1, estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period; and

(c) calculate the accumulated depreciation on that amount, as at the date of transition to HKFRSs, on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity in accordance with HKFRSs.

D21A An entity that uses the exemption in paragraph D8A(b) (for oil and gas assets in the development or production phases accounted for in cost centres that include all properties in a large geographical area under previous GAAP) shall, instead of applying paragraph D21 or HK(IFRIC)-Int 1:

(a) measure decommissioning, restoration and similar liabilities as at the date of transition to HKFRSs in accordance with HKAS 37; and

(b) recognise directly in retained earnings any difference between that amount and the carrying amount of those liabilities at the date of transition to HKFRSs determined under the entity's previous GAAP.

Financial assets or intangible assets accounted for in accordance with HK(IFRIC)-Int 12

D22 A first-time adopter may apply the transitional provisions in HK(IFRIC)-In 12.

Borrowing costs

D23 ~~A first-time adopter may apply the transitional provisions set out in paragraphs 27 and 28 of HKAS 23, as revised in 2007. In those paragraphs references to the effective date shall be interpreted as 1 January 2009 or the date of transition to HKFRSs, whichever is later.~~ A first-time adopter can elect to apply the requirements of HKAS 23 from the date of transition or from an earlier date as permitted by paragraph 28 of HKAS 23. From the date on which an entity that applies this exemption begins to apply HKAS 23, the entity:

(a) shall not restate the borrowing cost component that was capitalised under previous GAAP and that was included in the carrying amount of assets at that date; and

(b) shall account for borrowing costs incurred on or after that date in accordance with HKAS 23, including those borrowing costs incurred on or after that date on qualifying assets already under construction.

Transfers of assets from customers

D24 A first-time adopter may apply the transitional provisions set out in paragraph 22 of HK(IFRIC)-Int 18 *Transfers of Assets from Customers*. In that paragraph, reference to the effective date shall be interpreted as 1 July 2009 or the date of transition to HKFRSs, whichever is later. In addition, a first-time adopter may designate any date before the date of transition to HKFRSs and apply HK(IFRIC)-Int 18 to all transfers of assets from customers received on or after that date.

Extinguishing financial liabilities with equity instruments

D25 A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments*.

Severe hyperinflation

D26 If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of transition to HKFRSs. This applies to entities that are adopting HKFRSs for the first time, as well as entities that have previously applied HKFRSs.

D27 The currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics:

(a) a reliable general price index is not available to all entities with transactions and balances in the currency.

(b) exchangeability between the currency and a relatively stable foreign currency does not exist.

D28 The functional currency of an entity ceases to be subject to severe hyperinflation on the functional currency normalisation date. That is the date when the functional currency no longer has either, or both, of the characteristics in paragraph D27, or when there is a change in the entity's functional currency to a currency that is not subject to severe hyperinflation.

D29 When an entity's date of transition to HKFRSs is on, or after, the functional currency normalisation date, the entity may elect to measure all assets and liabilities held before the functional currency normalisation date at fair value on the date of transition to HKFRSs. The entity may use that fair value as the deemed cost of those assets and liabilities in the opening HKFRS statement of financial position.

D30 When the functional currency normalisation date falls within a 12-month comparative period, the comparative period may be less than 12 months, provided that a complete set of financial statements (as required by paragraph 10 of HKAS 1) is provided for that shorter period.

Joint arrangements

D31 A first-time adopter may apply the transition provisions in HKFRS 11 with the following exceptions:

(a) When applying the transition provisions in HKFRS 11, a first-time adopter shall apply these provisions at the date of transition to HKFRS.

(b) When changing from proportionate consolidation to the equity method, a first-time adopter shall test for impairment the investment in accordance with HKAS 36 as at the date of transition to HKFRS, regardless of whether there is any indication that the investment may be impaired. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to HKFRS.

Stripping costs in the production phase of a surface mine

D32 A first-time adopter may apply the transitional provisions set out in paragraphs A1 to A4 of HK(IFRIC)-Int 20 *Stripping Costs in the Production Phase of a Surface Mine*. In that paragraph, reference to the effective date shall be interpreted as 1 January 2013 or the beginning of the first HKFRS reporting period, whichever is later.

Appendix E
Short-term exemptions from HKFRSs

This appendix is an integral part of the HKFRS.

[*Paragraphs E1 and E2 are amendments that are not yet effective and are therefore not included in this edition.]*

Disclosures about financial instruments

E3 A first-time adopter may apply the transition provisions in paragraph 44G of HKFRS 7.*

E4 A first-time adopter may apply the transitional provisions in paragraph 44M of HKFRS 7.†

Employee benefits

E5 A first-time adopter may apply the transition provisions in paragraph 173(b) of HKAS 19.

* Paragraph E3 was added as a consequence of *Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters* (Amendment to HKFRS 1) issued in February 2010. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current HKFRS preparers, first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with HKFRSs that are included in *Improving Disclosures about Financial Instruments* (Amendments to HKFRS 7).

† Paragraph E4 was added as a consequence of *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7) issued in October 2010. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current HKFRS preparers, first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with HKFRSs that are included in *Disclosures—Transfers of Financial Assets* (Amendments to HKFRS 7).

APPENDIX F
Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared as at December 2008 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKFRS 1.

The International Financial Reporting Standard comparable with HKFRS 1 (Revised) is IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

The following sets out the major textual differences between HKFRS 1 (Revised) and IFRS 1 and the reasons for such differences.

Differences	**Reasons for the differences**
1. IFRS 1 Paras 3(a) and 4 **HKFRS 1 Paras 3(a) and 4** IFRS 1 contains references to "national" requirements whereas HKFRS 1 uses references to "other accounting" requirements.	IFRS 1 is an international statement whereas HKFRS 1 is a national statement.

HKFRS 1 (Revised) BC
Revised ~~June 2012~~July 2014

Effective for annual periods
beginning on or after 1 July 2009

Basis for Conclusions on
Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

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

Basis for Conclusions
IFRS 1 *First-time Adoption of International Financial Reporting Standards*

HKFRS 1 (Revised) is based on IFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards.* In approving HKFRS 1 (Revised), the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 1. Accordingly, there are no significant differences between HKFRS 1 (Revised) and IFRS 1. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 1 referred to below generally correspond with those in HKFRS 1 (Revised).

CONTENTS

Basis for Conclusions on IFRS 1 *First-time Adoption of International Financial Reporting Standards*

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

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements *(as revised in 2007).*

This Basis for Conclusions has not been revised to reflect the restructuring of FRS 1 in November 2008, but cross-references have been updated.

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

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Individual Board members gave greater weight to some factors than to others.

BC2 SIC-8 *First-time Application of IASs as the Primary Basis of Accounting*, issued in 1998, dealt with matters that arose when an entity first adopted IASs. In 2001, the Board began a project to review SIC-8. In July 2002, the Board published ED 1 *First-time Application of International Financial Reporting Standards*, with a comment deadline of 31 October 2002. The Board received 83 comment letters on ED 1. IFRS 1 was issued by the Board in June 2003.

BC2A IFRS 1 replaced SIC-8. The Board developed the IFRS to address concerns that:

(a) some aspects of SIC-8's requirement for full retrospective application caused costs that exceeded the likely benefits for users of financial statements. Moreover, although SIC-8 did not require retrospective application when this would be impracticable, it did not explain whether a first-time adopter should interpret impracticability as a high hurdle or a low hurdle and it did not specify any particular treatment in cases of impracticability.

(b) SIC-8 could require a first-time adopter to apply two different versions of a standard if a new version were introduced during the periods covered by its first financial statements prepared under IASs and the new version prohibited retrospective application.

(c) SIC-8 did not state clearly whether a first-time adopter should use hindsight in applying recognition and measurement decisions retrospectively.

(d) there was some doubt about how SIC-8 interacted with specific transitional provisions in individual standards.

BC2B Like SIC-8, IFRS 1 requires retrospective application in most areas. Unlike SIC-8, it:

(a) includes targeted exemptions to avoid costs that would be likely to exceed the benefits to users of financial statements, and a small number of other exceptions for practical reasons.

(b) clarifies that an entity applies the latest version of IFRSs.

(c) clarifies how a first-time adopter's estimates in accordance with IFRSs relate to the estimates it made for the same date in accordance with previous GAAP.

(d) specifies that the transitional provisions in other IFRSs do not apply to a first-time adopter.

(e) requires enhanced disclosure about the transition to IFRSs.

BC3 The project took on added significance because of the requirement for listed European Union companies to adopt IFRSs in their consolidated financial statements from 2005. Several other countries announced that they would permit or require entities to adopt IFRSs in the next few years. Nevertheless, the Board's aim in developing the IFRS was to find solutions that would be appropriate for any entity, in any part of the world, regardless of whether adoption occurs in 2005 or at a different time.

Restructuring of the IFRS

BC3A Since it was issued in 2003, IFRS 1 has been amended many times to accommodate first-time adoption requirements resulting from new or amended IFRSs. Because of the way IFRS 1 was structured, those amendments made the IFRS more complex and less clear. As more amendments become necessary, this problem will become worse.

BC3B As part of its improvements project in 2007, therefore, the Board proposed to change the structure of IFRS 1 without amending its substance. Respondents to the exposure draft published in October 2007 supported the restructuring. The revised structure of the IFRS issued in November 2008 is easier for the reader to understand and is better designed to accommodate future changes. The focus of the restructuring was to move to appendices all specific exemptions and exceptions from the requirements of IFRSs. Exemptions are categorised into business combinations, exemptions and short-term exemptions. Exemptions are applicable to all first-time adopters regardless of their date of transition to IFRSs. Short-term exemptions are those exemptions applicable to users for a short time. Once those exemptions have become out of date, they will be deleted.

Scope

BC4 The IFRS applies to an entity that presents its first IFRS financial statements (a first-time adopter). Some suggested that an entity should not be regarded as a first-time adopter if its previous financial statements contained an explicit statement of compliance with IFRSs, except for specified (and explicit) departures. They argued that an explicit statement of compliance establishes that an entity regards IFRSs as its basis of accounting, even if the entity does not comply with every requirement of every IFRS. Some regarded this argument as especially strong if an entity previously complied with all recognition and measurement requirements of IFRSs, but did not give some required disclosures—for example, segmental disclosures that IAS 14 *Segment Reporting*[*] requires or the explicit statement of compliance with IFRSs that IAS 1 *Presentation of Financial Statements* requires.

BC5 To implement that approach, it would be necessary to establish how many departures are needed—and how serious they must be—before an entity would conclude that it has not adopted IFRSs. In the Board's view, this would lead to complexity and uncertainty. Also, an entity should not be regarded as having adopted IFRSs if it does not give all disclosures required by IFRSs, because that approach would diminish the importance of disclosures and undermine efforts to promote full compliance with IFRSs. Therefore, the IFRS contains a simple test that gives an unambiguous answer: an entity has adopted IFRSs if, and only if, its financial statements contain an explicit and unreserved statement of compliance with IFRSs (paragraph 3 of the IFRS).

BC6 If an entity's financial statements in previous years contained that statement, any material disclosed or undisclosed departures from IFRSs are errors. The entity applies IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in correcting them.

[*] In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*.

Repeated application of IFRS 1

BC6A In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed a request to clarify whether an entity may apply IFRS 1:

(a) if the entity meets the criteria for applying IFRS 1 and has applied IFRS 1 in a previous reporting period; or

(b) if the entity meets the criteria for applying IFRS 1 and has applied IFRSs in a previous reporting period when IFRS 1 did not exist.

For example, an entity may have applied IFRS 1 in a previous reporting period to meet listing requirements in a foreign jurisdiction. The entity then delists and no longer presents financial statements in accordance with IFRSs. In a subsequent reporting period, the reporting requirements in the entity's local jurisdiction may change from national GAAP to IFRSs. Consequently, the entity is again required to present its financial statements in accordance with IFRSs.

BC6B The Board noted that the scope of IFRS 1 focuses on whether an entity's financial statements are its first IFRS financial statements (a term defined in Appendix A). If an entity's financial statements meet the definition of 'first IFRS financial statements', the entity is required to apply IFRS 1 in accordance with paragraph 2(a). However, use of the term 'first' raises the question whether IFRS 1 can be applied more than once.

BC6C In the June 2011 exposure draft the Board proposed to clarify that an entity is required to apply IFRS 1 when the entity's most recent previous annual financial statements do not contain an explicit and unreserved statement of compliance with IFRSs, even if the entity has applied IFRS 1 in a reporting period before the period reported in the most recent previous annual financial statements. However, in the light of respondents' comments on the June 2011 exposure draft, the Board decided that an entity that meets the criteria for applying IFRS 1 and that has applied IFRSs in a previous reporting period (regardless of whether it used IFRS 1 or SIC-8 *First-Time Application of IASs*, if either, when previously adopting) may choose to apply IFRS 1 when it re-adopts IFRSs. The Board decided that the entity should be allowed, rather than required, to apply IFRS 1 because, as explained in paragraph IN5 of IFRS 1, IFRS 1 grants limited exemptions from some requirements of IFRSs on the assumption that the cost of complying with some IFRSs would be likely to exceed the benefits to users of financial statements. However, the costs of applying IFRSs in full might not exceed the benefits of doing so for an entity that had previously applied IFRSs. Consequently, the Board concluded that an entity returning to IFRSs might determine that the benefits of applying IFRSs as if it had continued to do so without interruption would exceed the costs of preparing such information, and that an entity should not be prohibited from following that approach. In applying such an approach, an entity should apply IFRSs retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Estimates and Errors* as if the entity had never stopped applying IFRSs. The Board noted that hindsight is not applied by an entity in preparing IFRS financial statements, whether that entity is applying IFRS 1, or whether that entity applies IFRSs retrospectively as if the entity had never stopped applying them in accordance with IAS 8. The Board noted that paragraphs 14–17 of IFRS 1 and paragraph 53 of IAS 8 provide guidance in this regard.

BC6D The Board also noted that, in accordance with paragraph 2 of IFRS 1, an entity that has never applied IFRSs in the past would continue to be required to apply IFRS 1 in its first IFRS financial statements.

BC6E The Board also decided that the entity shall disclose the reason why it stopped applying IFRSs and the reason why it is resuming reporting in accordance with IFRSs. The Board thinks that this disclosure requirement provides users with useful information and would discourage the intentional omission of the statement of compliance with IFRSs solely to allow an entity to take advantage of the exemptions in IFRS 1. The Board also decided that an entity that does not elect to apply IFRS 1 shall explain the reasons why it has elected to apply IFRSs as if it had never stopped applying them. The Board believes that this disclosure ensures that useful information will be provided to users.

Basic concepts

Useful information for users

BC7 In developing recognition and measurement requirements for an entity's opening IFRS balance sheet, the Board referred to the objective of financial statements, as set out in the *Framework for the Preparation and Presentation of Financial Statements*. The *Framework* states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

BC8 The *Framework* identifies four qualitative characteristics that make information in financial statements useful to users. In summary, the information should be:

(a) readily understandable by users.

(b) relevant to the decision-making needs of users.

(c) reliable, in other words financial statements should:

(i) represent faithfully the transactions and other events they either purport to represent or could reasonably be expected to represent;

(ii) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;

(iii) be neutral, that is to say, free from bias;

(iv) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and

(v) be complete within the bounds of materiality and cost.

(d) comparable with information provided by the entity in its financial statements through time and with information provided in the financial statements of other entities.

Comparability

BC9 The previous paragraph notes the need for comparability. Ideally, a regime for first-time adoption of IFRSs would achieve comparability:

(a) within an entity over time;

(b) between different first-time adopters; and

(c) between first-time adopters and entities that already apply IFRSs.

BC10 SIC-8 gave priority to ensuring comparability between a first-time adopter and entities that already applied IASs. It was based on the principle that a first-time adopter should comply with the same standards as an entity that already applied IASs. However, the Board decided that it is more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective.

Current version of IFRSs

BC11 Paragraphs 7–9 of the IFRS require a first-time adopter to apply the current version of IFRSs, without considering superseded or amended versions. This:

(a) enhances comparability, because the information in a first-time adopter's first IFRS financial statements is prepared on a consistent basis over time;

(b) gives users comparative information prepared using later versions of IFRSs that the Board regards as superior to superseded versions; and

(c) avoids unnecessary costs.

BC12 In general, the transitional provisions in other IFRSs do not apply to a first-time adopter (paragraph 9 of the IFRS). Some of these transitional provisions require or permit an entity already reporting in accordance with IFRSs to apply a new requirement prospectively. These provisions generally reflect a conclusion that one or both of the following factors are present in a particular case:

(a) Retrospective application may be difficult or involve costs exceeding the likely benefits. The IFRS permits prospective application in specific cases where this could occur (paragraphs BC30–BC73).

(b) There is a danger of abuse if retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known. The IFRS prohibits retrospective application in some areas where this could occur (paragraphs BC74–BC84).

BC13 Some have suggested three further reasons for permitting or requiring prospective application in some cases:

(a) to alleviate unforeseen consequences of a new IFRS if another party uses financial statements to monitor compliance with a contract or agreement. However, in the Board's view, it is up to the parties to an agreement to determine whether to insulate the agreement from the effects of a future IFRS and, if not, how they might renegotiate it so that it reflects changes in the underlying financial condition rather than changes in reporting (paragraph 21* of the *Preface to International Financial Reporting Standards*).

(b) to give a first-time adopter the same accounting options as an entity that already applies IFRSs. However, permitting prospective application by a first-time adopter would conflict with the Board's primary objective of comparability within an entity's first IFRS financial statements (paragraph BC10). Therefore, the Board did not adopt a general policy of giving first-time adopters the same accounting options of prospective application that existing IFRSs give to entities that already apply IFRSs. Paragraphs BC20–BC23 discuss one specific case, namely derecognition of financial assets and financial liabilities.

(c) to avoid difficult distinctions between changes in estimates and changes in the basis for making estimates. However, a first-time adopter need not make this distinction in preparing its opening IFRS balance sheet, so the IFRS does not include exemptions on these grounds. If an entity becomes aware of errors made under previous GAAP, the IFRS requires it to disclose the correction of the errors (paragraph 26 of the IFRS).

BC14 The Board will consider case by case when it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. However, if the Board concludes in a particular case that prospective application by a first-time adopter is justified, it will amend the IFRS on first-time adoption of IFRSs. As a result, IFRS 1 will contain all material on first-time adoption of IFRSs and other IFRSs will not refer to first-time adopters (except, when needed, in the Basis for Conclusions and consequential amendments).

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* amended to paragraph 20 when the *Preface* was revised in January 2010.

BC15 Under the proposals in ED 1, a first-time adopter could have elected to apply IFRSs as if it had always applied IFRSs. This alternative approach was intended mainly to help an entity that did not wish to use any of the exemptions proposed in ED 1 because it had already been accumulating information in accordance with IFRSs without presenting IFRS financial statements. To enable an entity using this approach to use the information it had already accumulated, ED 1 would have required it to consider superseded versions of IFRSs if more recent versions required prospective application. However, as explained in paragraphs BC28 and BC29, the Board abandoned ED 1's all-or-nothing approach to exemptions. Because this eliminated the reason for the alternative approach, the Board deleted it in finalising the IFRS.

Opening IFRS balance sheet

BC16 An entity's opening IFRS balance sheet is the starting point for its accounting in accordance with IFRSs. The following paragraphs explain how the Board used the *Framework* in developing recognition and measurement requirements for the opening IFRS balance sheet.

Recognition

BC17 The Board considered a suggestion that the IFRS should not require a first-time adopter to investigate transactions that occurred before the beginning of a 'look back' period of, say, three to five years before the date of transition to IFRSs. Some argued that this would be a practical way for a first-time adopter to give a high level of transparency and comparability, without incurring the cost of investigating very old transactions. They noted two particular precedents for transitional provisions that have permitted an entity to omit some assets and liabilities from its balance sheet:

(a) A previous version of IAS 39 *Financial Instruments: Recognition and Measurement* prohibited restatement of securitisation, transfer or other derecognition transactions entered into before the beginning of the financial year in which it was initially applied.

(b) Some national accounting standards and IAS 17 *Accounting for Leases* (superseded in 1997 by IAS 17 *Leases*) permitted prospective application of a requirement for lessees to capitalise finance leases. Under this approach, a lessee would not be required to recognise finance lease obligations and the related leased assets for leases that began before a specified date.

BC18 However, limiting the look back period could lead to the omission of material assets or liabilities from an entity's opening IFRS balance sheet. Material omissions would undermine the understandability, relevance, reliability and comparability of an entity's first IFRS financial statements. Therefore, the Board concluded that an entity's opening IFRS balance sheet should:

(a) include all assets and liabilities whose recognition is required by IFRSs, except:

  (i) some financial assets or financial liabilities derecognised in accordance with previous GAAP before the date of transition to IFRSs (paragraphs BC20–BC23); and

  (ii) goodwill and other assets acquired, and liabilities assumed, in a past business combination that were not recognised in the acquirer's consolidated balance sheet in accordance with previous GAAP and also would not qualify for recognition in accordance with IFRSs in the balance sheet of the acquiree (paragraphs BC31–BC40).

(b) not report items as assets or liabilities if they do not qualify for recognition in accordance with IFRSs.

BC19 Some financial instruments may be classified as equity in accordance with previous GAAP but as financial liabilities in accordance with IAS 32 *Financial Instruments: Presentation*. Some respondents to ED 1 requested an extended transitional period to enable the issuer of such instruments to renegotiate contracts that refer to debt-equity ratios. However, although a new

IFRS may have unforeseen consequences if another party uses financial statements to monitor compliance with a contract or agreement, that possibility does not, in the Board's view, justify prospective application (paragraph BC13(a)).

Derecognition in accordance with previous GAAP

BC20 An entity may have derecognised financial assets or financial liabilities in accordance with its previous GAAP that do not qualify for derecognition in accordance with IAS 39. ED 1 proposed that a first-time adopter should recognise those assets and liabilities in its opening IFRS balance sheet. Some respondents to ED 1 requested the Board to permit or require a first-time adopter not to restate past derecognition transactions, on the following grounds:

(a) Restating past derecognition transactions would be costly, especially if restatement involves determining the fair value of retained servicing assets and liabilities and other components retained in a complex securitisation. Furthermore, it may be difficult to obtain information on financial assets held by transferees that are not under the transferor's control.

(b) Restatement undermines the legal certainty expected by parties who entered into transactions on the basis of the accounting rules in effect at the time.

(c) IAS 39 did not, before the improvements proposed in June 2002, require (or even permit) entities to restate past derecognition transactions. Without a similar exemption, first-time adopters would be unfairly disadvantaged.

(d) Retrospective application would not result in consistent measurement, as entities would need to recreate information about past transactions with the benefit of hindsight.

BC21 The Board had considered these arguments in developing ED 1. The Board's reasons for the proposal in ED 1 were as follows:

(a) The omission of material assets or liabilities would undermine the understandability, relevance, reliability and comparability of an entity's financial statements. Many of the transactions under discussion are large and will have effects for many years.

(b) Such an exemption would be inconsistent with the June 2002 exposure draft of improvements to IAS 39.

(c) The Board's primary objective is to achieve comparability over time within an entity's first IFRS financial statements. Prospective application by a first-time adopter would conflict with that primary objective, even if prospective application were available to entities already applying IFRSs.

(d) Although a new IFRS may have unforeseen consequences if another party uses financial statements to monitor compliance with a contract or agreement, that possibility does not justify prospective application (paragraph BC13(a)).

BC22 Nevertheless, in finalising the IFRS, the Board concluded that it would be premature to require a treatment different from the current version of IAS 39 before completing the proposed improvements to IAS 39. Accordingly, the IFRS originally required the same treatment as the then current version of IAS 39 for derecognition transactions before the effective date of the then current version of IAS 39, namely that any financial assets or financial liabilities derecognised in accordance with previous GAAP before financial years beginning on 1 January 2001 remain derecognised. The Board agreed that when it completed the improvements to IAS 39, it might amend or delete this exemption.

BC22A The Board reconsidered this issue in completing the revision of IAS 39 in 2003. The Board decided to retain the transition requirements as set out in IFRS 1, for the reasons given in paragraph BC20. However, the Board amended the date from which prospective application was required to transactions that occur on or after 1 January 2004 in order to overcome the practical difficulties of restating transactions that had been derecognised before that date. In 2010 the Board was asked to reconsider whether 1 January 2004 is the appropriate date from which a first-time adopter should be required to restate past derecognition transactions. Constituents were concerned that, as time passes, the fixed transition date of 1 January 2004 becomes more remote and increasingly less relevant to the financial reports as additional jurisdictions adopt IFRSs. The Board accepted that the cost of reconstructing transactions back in time to 1 January 2004 was likely to outweigh the benefit to be achieved in doing so. It therefore amended the fixed date of 1 January 2004 in paragraph B2 to 'the date of transition to IFRSs'. The Board also amended the wording of the illustration in paragraph B2, in order to clarify that it is providing an example.

BC22B The Board also noted that financial statements that include financial assets and financial liabilities that would otherwise be omitted under the provisions of the IFRS would be more complete and therefore more useful to users of financial statements. The Board therefore decided to permit retrospective application of the derecognition requirements. It also decided that retrospective application should be limited to cases when the information needed to apply the IFRS to past transactions was obtained at the time of initially accounting for those transactions. This limitation prevents the unacceptable use of hindsight.

BC23 The Board removed from IAS 39 the following consequential amendments to IAS 39 made when IFRS 1 was issued, because, for first-time adopters, these clarifications are clear in paragraphs IG26–IG31 and IG53 of the guidance on implementing IFRS 1. These were:

(a) the clarification that an entity is required to apply IAS 39 to all derivatives or other interests retained after a derecognition transaction, even if the transaction occurred before the effective date of IAS 39; and

(b) the confirmation that there are no exemptions for special purpose entities[*] that existed before the date of transition to IFRSs.

Measurement

BC24 The Board considered whether it should require a first-time adopter to measure all assets and liabilities at fair value in the opening IFRS balance sheet. Some argued that this would result in more relevant information than an aggregation of costs incurred at different dates, or of costs and fair values. However, the Board concluded that a requirement to measure all assets and liabilities at fair value at the date of transition to IFRSs would be unreasonable, given that an entity may use an IFRS-compliant cost-based measurement before and after that date for some items.

BC25 The Board decided as a general principle that a first-time adopter should measure all assets and liabilities recognised in its opening IFRS balance sheet on the basis required by the relevant IFRSs. This is needed for an entity's first IFRS financial statements to present understandable, relevant, reliable and comparable information.

Benefits and costs

BC26 The *Framework* acknowledges that the need for a balance between the benefits of information and the cost of providing it may constrain the provision of relevant and reliable information. The Board considered these cost-benefit constraints and developed targeted exemptions from the general principle described in paragraph BC25. SIC-8 did not include specific exemptions of this kind, although it provided general exemptions from:

(a) retrospective adjustments to the opening balance of retained earnings 'when the amount of the adjustment relating to prior periods cannot be reasonably determined'.

[*] SIC-12 *Consolidation-Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

(b) provision of comparative information when it is ‘impracticable’ to provide such information.

BC27 The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board took as its benchmark an entity that plans the transition well in advance and can collect most information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs.

BC28 ED 1 proposed that a first-time adopter should use either all the exemptions in ED 1 or none. However, some respondents disagreed with this all or nothing approach for the following reasons:

(a) Many of the exemptions are not interdependent, so there is no conceptual reason to condition use of one exemption on use of other exemptions.

(b) Although it is necessary to permit some exemptions on pragmatic grounds, entities should be encouraged to use as few exemptions as possible.

(c) Some of the exemptions proposed in ED 1 were implicit options because they relied on the entity’s own judgement of undue cost or effort and some others were explicit options. Only a few exemptions were really mandatory.

(d) Unlike the other exceptions to retrospective application, the requirement to apply hedge accounting prospectively was not intended as a pragmatic concession on cost benefit grounds. Retrospective application in an area that relies on designation by management would not be acceptable, even if an entity applied all other aspects of IFRSs retrospectively.

BC29 The Board found these comments persuasive. In finalising the IFRS, the Board grouped the exceptions to retrospective application into two categories:

(a) Some exceptions consist of optional exemptions (paragraphs BC30–BC63E).

(b) The other exceptions prohibit full retrospective application of IFRSs to some aspects of derecognition (paragraphs BC20–BC23), hedge accounting (paragraphs BC75–BC80), and estimates (paragraph BC84).

Exemptions from other IFRSs

BC30 An entity may elect to use one or more of the following exemptions:

(a) business combinations (paragraphs BC31–BC40);

(b) deemed cost (paragraphs BC41–BC47E);

(c) employee benefits (paragraphs BC48–BC52);

(d) cumulative translation differences (paragraphs BC53–BC55);

(e) compound financial instruments (paragraphs BC56–BC58);

(f) investments in subsidiaries, jointly controlled entities[*] and associates (paragraphs BC58A–BC58M);

(g) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs BC59–BC63);

(h) designation of previously recognised financial instruments (paragraph BC63A);

(i) share-based payment transactions (paragraph BC63B);

[*] 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

(j) changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment (paragraphs BC63C and BC63CA);

(k) leases (paragraphs BC63D-BC63DB);

(l) borrowing costs (paragraph BC63E); ~~and~~

(m) severe hyperinflation (paragraphs BC63F – BC63J)~~.~~; and

(n) joint arrangements (paragraphs BC63K and BC63L).

Business combinations

BC31 The following paragraphs discuss various aspects of accounting for business combinations that an entity recognised in accordance with previous GAAP before the date of transition to IFRSs:

(a) whether retrospective restatement of past business combinations should be prohibited, permitted or required (paragraphs BC32–BC34).

(b) whether an entity should recognise assets acquired and liabilities assumed in a past business combination if it did not recognise them in accordance with previous GAAP (paragraph BC35).

(c) whether an entity should restate amounts assigned to the assets and liabilities of the combining entities if previous GAAP brought forward unchanged their pre-combination carrying amounts (paragraph BC36).

(d) whether an entity should restate goodwill for adjustments made in its opening IFRS balance sheet to the carrying amounts of assets acquired and liabilities assumed in past business combinations (paragraphs BC37–BC40).

BC32 Retrospective application of IFRS 3 *Business Combinations* could require an entity to recreate data that it did not capture at the date of a past business combination and make subjective estimates about conditions that existed at that date. These factors could reduce the relevance and reliability of the entity's first IFRS financial statements. Therefore, ED 1 would have prohibited restatement of past business combinations (unless an entity used the proposed alternative approach, discussed in paragraph BC15, of applying IFRSs as if it had always applied IFRSs). Some respondents agreed, arguing that restatement of past business combinations would involve subjective, and potentially selective, use of hindsight that would diminish the relevance and reliability of financial statements.

BC33 Other respondents disagreed. They argued that:

(a) effects of business combination accounting can last for many years. Previous GAAP may differ significantly from IFRSs, and in some countries there are no accounting requirements at all for business combinations. Previous GAAP balances might not result in decision-useful information in these countries.

(b) restatement is preferable and may not involve as much cost or effort for more recent business combinations.

BC34 In the light of these comments, the Board concluded that restatement of past business combinations is conceptually preferable, although for cost-benefit reasons this should be permitted but not required. The Board decided to place some limits on this election and noted that information is more likely to be available for more recent business combinations. Therefore, if a first-time adopter restates any business combination, the IFRS requires it to restate all later business combinations (paragraph C1 of the IFRS).

BC35 If an entity did not recognise a particular asset or liability in accordance with previous GAAP at the date of the business combination, ED 1 proposed that its deemed cost in accordance with IFRSs would be zero. As a result, the entity's opening IFRS balance sheet would not have included that asset or liability if IFRSs permit or require a cost-based measurement. Some respondents to ED 1 argued that this would be an unjustifiable departure from the principle that the opening IFRS balance sheet should include all assets and liabilities. The Board agreed with that conclusion. Therefore, paragraph C4(f) of the IFRS requires that the acquirer should recognise those assets and liabilities and measure them on the basis that IFRSs would require in the separate balance sheet of the acquiree.

BC36 In accordance with previous GAAP, an entity might have brought forward unchanged the pre-combination carrying amounts of the combining entities' assets and liabilities. Some argued that it would be inconsistent to use these carrying amounts as deemed cost in accordance with IFRSs, given that the IFRS does not permit the use of similar carrying amounts as deemed cost for assets and liabilities that were not acquired in a business combination. However, the Board identified no specific form of past business combination, and no specific form of accounting for past business combinations, for which it would not be acceptable to bring forward cost-based measurements made in accordance with previous GAAP.

BC37 Although the IFRS treats amounts assigned in accordance with previous GAAP to goodwill and other assets acquired and liabilities assumed in a past business combination as their deemed cost in accordance with IFRSs at the date of the business combination, an entity needs to adjust their carrying amounts in its opening IFRS balance sheet, as follows.

(a) Assets and liabilities measured in accordance with IFRSs at fair value* or other forms of current value: remeasure to fair value or that other current value.

(b) Assets (other than goodwill) and liabilities for which IFRSs apply a cost-based measurement: adjust the accumulated depreciation or amortisation since the date of the business combination if it does not comply with IFRSs. Depreciation is based on deemed cost, which is the carrying amount in accordance with previous GAAP immediately following the business combination.

(c) Assets (other than goodwill) and liabilities not recognised in accordance with previous GAAP: measure on the basis that IFRSs would require in the separate balance sheet of the acquiree.

(d) Items that do not qualify for recognition as assets and liabilities in accordance with IFRSs: eliminate from the opening IFRS balance sheet.

BC38 The Board considered whether a first-time adopter should recognise the resulting adjustments by restating goodwill. Because intangible assets and goodwill are closely related, the Board decided that a first-time adopter should restate goodwill when it:

(a) eliminates an item that was recognised in accordance with previous GAAP as an intangible asset but does not qualify for separate recognition in accordance with IFRSs; or

(b) recognises an intangible asset that was subsumed within goodwill in accordance with previous GAAP.

However, to avoid costs that would exceed the likely benefits to users, the IFRS prohibits restatement of goodwill for most other adjustments reflected in the opening IFRS balance sheet, unless a first-time adopter elects to apply IFRS 3 retrospectively (paragraph C4(g) of the IFRS).

BC39 To minimise the possibility of doubl-counting an item that was included in goodwill in accordance with previous GAAP, and is included in accordance with IFRSs either within the measurement of another asset or as a deduction from a liability, the IFRS requires an entity to test goodwill recognised in its opening IFRS balance sheet for impairment (paragraph C4(g)(ii) of the IFRS).

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

This does not prevent the implicit recognition of internally generated goodwill that arose after the date of the business combination. However, the Board concluded that an attempt to exclude such internally generated goodwill would be costly and lead to arbitrary results.

BC40 Some respondents to ED 1 suggested that a formal impairment test should be required only if there is a possibility of double-counting—ie when additional, previously unrecognised, assets relating to a past business combination are recognised in the opening IFRS balance sheet (or an indicator of impairment is present). However, the Board decided that a first-time adopter should carry out a formal impairment test of all goodwill recognised in its opening IFRS balance sheet, as previous GAAP might not have required a test of comparable rigour.

Deemed cost

BC41 Some measurements in accordance with IFRSs are based on an accumulation of past costs or other transaction data. If an entity has not previously collected the necessary information, collecting or estimating it retrospectively may be costly. To avoid excessive cost, ED 1 proposed that an entity could use the fair value of an item of property, plant and equipment at the date of transition to IFRSs as its deemed cost at that date if determining a cost-based measurement in accordance with IFRSs would involve undue cost or effort.

BC42 In finalising the IFRS, the Board noted that reconstructed cost data might be less relevant to users, and less reliable, than current fair value data. Furthermore, the Board concluded that balancing costs and benefits was a task for the Board when it sets accounting requirements rather than for entities when they apply those requirements. Therefore, the IFRS permits an entity to use fair value as deemed cost in some cases without any need to demonstrate undue cost or effort.

BC43 Some expressed concerns that the use of fair value would lead to lack of comparability. However, cost is generally equivalent to fair value at the date of acquisition. Therefore, the use of fair value as the deemed cost of an asset means that an entity will report the same cost data as if it had acquired an asset with the same remaining service potential at the date of transition to IFRSs. If there is any lack of comparability, it arises from the aggregation of costs incurred at different dates, rather than from the targeted use of fair value as deemed cost for some assets. The Board regarded this approach as justified to solve the unique problem of introducing IFRSs in a cost-effective way without damaging transparency.

BC44 The IFRS restricts the use of fair value as deemed cost to those assets for which reconstructing costs is likely to be of limited benefit to users and particularly onerous: property, plant and equipment, investment property (if an entity elects to use the cost method in IAS 40 *Investment Property*) and intangible assets that meet restrictive criteria (paragraphs D5 and D7 of the IFRS).

BC45 Under the revaluation model in IAS 16 *Property, Plant and Equipment*, if an entity revalues an asset, it must revalue all assets in that class. This restriction prevents selective revaluation of only those assets whose revaluation would lead to a particular result. Some suggested a similar restriction on the use of fair value as deemed cost. However, IAS 36 *Impairment of Assets* requires an impairment test if there is any indication that an asset is impaired. Thus, if an entity uses fair value as deemed cost for assets whose fair value is above cost, it cannot ignore indications that the recoverable amount of other assets may have fallen below their carrying amount. Therefore, the IFRS does not restrict the use of fair value as deemed cost to entire classes of asset.

BC46 Some revaluations in accordance with previous GAAP might be more relevant to users than original cost. If so, it would not be reasonable to require time-consuming and expensive reconstruction of a cost that complies with IFRSs. In consequence, the IFRS permits an entity to use amounts determined using previous GAAP as deemed cost for IFRSs in the following cases:

(a) if an entity revalued one of the assets described in paragraph BC44 using its previous GAAP and the revaluation met specified criteria (paragraphs D6 and D7 of the IFRS).

(b) if an entity established a deemed cost in accordance with previous GAAP for some or all assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering (paragraph D8 of the IFRS).

BC46A In *Improvements to IFRSs* issued in May 2010, the Board extended the scope of paragraph D8 for the use of the deemed cost exemption for an event-driven fair value. In some jurisdictions, local law requires an entity to revalue its assets and liabilities to fair value for a privatisation or initial public offering (IPO) and to treat the revalued amounts as deemed cost for the entity's previous GAAP. Before the amendment made in May 2010, if that revaluation occurred after the entity's date of transition to IFRSs, the entity could not have used that revaluation as deemed cost for IFRSs. Therefore, the entity would have had to prepare two sets of measurements for its assets and liabilities—one to comply with IFRSs, and one to comply with local law. The Board considered this unduly onerous. Therefore, the Board amended paragraph D8 to allow an entity to recognise an event-driven fair value measurement as deemed cost when the event occurs, provided that this is during the periods covered by its first IFRS financial statements. In addition, the Board concluded that the same relief should apply to an entity that adopted IFRSs in periods before the effective date of IFRS 1 or applied IFRS 1 in a previous period, provided the measurement date is within the period covered by its first IFRS financial statements.

BC46B The Board also decided to require the entity to present historical costs or other amounts already permitted by IFRS 1 for the periods before that date. In this regard, the Board considered an approach where an entity could 'work back' to the deemed cost on the date of transition, using the revaluation amounts obtained on the measurement date, adjusted to exclude any depreciation, amortisation or impairment between the two dates. Although some believed that this presentation would have provided greater comparability throughout the first IFRS reporting period, the Board rejected it because making such adjustments would require hindsight and the computed carrying amounts on the date of transition to IFRSs would be neither the historical costs of the revalued assets nor their fair values on that date.

BC47 Paragraph D6 of the IFRS refers to revaluations that are broadly comparable to fair value or reflect an index applied to a cost that is broadly comparable to cost determined in accordance with IFRSs. It may not always be clear whether a previous revaluation was intended as a measure of fair value or differs materially from fair value. The flexibility in this area permits a cost-effective solution for the unique problem of transition to IFRSs. It allows a first-time adopter to establish a deemed cost using a measurement that is already available and is a reasonable starting point for a cost-based measurement.

BC47A Under their previous GAAP many oil and gas entities accounted for exploration and development costs for properties in development or production in cost centres that include all properties in a large geographical area. (In some jurisdictions, this is referred to as full cost accounting.) Those entities will in most cases have to determine the carrying amounts for oil and gas assets at the date of transition to IFRSs. Information about oil and gas assets recorded in an accounting system using this method of accounting will almost always be at a larger unit of account than the unit of account that is acceptable under IFRSs. Amortisation at the IFRS unit of account level would also have to be calculated (on a unit of production basis) for each year, using a reserves base that has changed over time because of changes in factors such as geological understanding and prices for oil and gas. In many cases, particularly for older assets, this information may not be available. The Board was advised that even if such information is available the effort and associated cost to determine the opening balances at the date of transition would usually be very high.

BC47B IFRS 1 permits an entity to measure an item of property, plant and equipment at its fair value at the date of transition to IFRSs and to use that fair value as the item's deemed cost at that date. Determining the fair value of oil and gas assets is a complex process that begins with the difficult task of estimating the volume of reserves and resources. When the fair value amounts must be audited, determining significant inputs to the estimates generally requires the use of qualified external experts. For entities with many oil and gas assets, the use of this fair value as deemed cost alternative would not meet the Board's stated intention of avoiding excessive cost (see paragraph BC41).

BC47C The Board decided that for oil and gas assets in the development or production phases, it would permit entities that used the method of accounting described in paragraph BC47A under their previous GAAP to determine the deemed cost at the date of transition to IFRSs using an allocation of the amount determined for a cost centre under the entity's previous GAAP on the basis of the reserves associated with the oil and gas assets in that cost centre.

BC47D The deemed cost of oil and gas assets determined in this way may include amounts that would not have been capitalised in accordance with IFRSs, such as some overhead costs, costs that were incurred before the entity obtained legal rights to explore a specific area (and cannot be capitalised in accordance with IAS 38 *Intangible Assets*) and, most significantly, unsuccessful exploration costs. This is a consequence of having included these costs in the single carrying amount under the method of accounting described in paragraph BC47A. To avoid the use of deemed costs resulting in an oil and gas asset being measured at more than its recoverable amount, the Board decided that oil and gas assets should be tested for impairment at the date of transition to IFRSs.

BC47E Not all oil and gas entities used the method of accounting described in paragraph BC47A under their previous GAAP. Some used a method of accounting that requires a unit of account that is generally consistent with IFRSs and does not cause similar transition issues. Therefore, the Board decided that the exemption would apply only to entities that used the method of accounting described in paragraph BC47A under their previous GAAP.

BC47F In *Improvements to IFRSs* issued in May 2010, the Board extended the use of the deemed cost exemption to entities with operations subject to rate regulation. An entity might have items of property, plant and equipment or intangible assets that it holds for use in operations subject to rate regulation, or that it once used for this purpose and now holds for other purposes. Under previous GAAP, an entity might have capitalised, as part of the carrying amount of items of property, plant and equipment or intangible assets held for use in operations subject to rate regulation, amounts that do not qualify for capitalisation under IFRSs. For example, when setting rates regulators often permit entities to capitalise, as part of the cost of property, plant and equipment or intangible assets acquired, constructed or produced over time, an allowance for the cost of financing the asset's acquisition, construction or production. This allowance typically includes an imputed cost of equity. IFRSs do not permit an entity to capitalise an imputed cost of equity.

BC47G Before this amendment, an entity with such items whose carrying amounts include amounts that do not qualify for capitalisation under IFRSs would have had either to restate those items retrospectively to remove the non-qualifying amounts, or to use the exemption in paragraphD5 (fair value as deemed cost). Both of those alternatives pose significant practical challenges, the cost of which can often outweigh the benefit.

BC47H Typically, once amounts are included in the total cost of an item of property, plant and equipment, they are no longer tracked separately. The restatement of property, plant and equipment to remove amounts not in compliance with IFRSs would require historical information that, given the typical age of some of the assets involved, is probably no longer available and would be difficult to estimate. Obtaining the fair value information necessary to use the exemption in paragraph D5 may not be a practical alternative, given the lack of readily available fair value information for those assets.

BC47I The Board decided it would permit entities with operations subject to rate regulation to use as deemed cost at the date of transition to IFRSs the carrying amount of the items of property, plant and equipment or intangible assets determined under the entity's previous GAAP. The Board views this exemption as consistent with the exemptions already included in IFRS 1 in that it avoids excessive costs while meeting the objectives of the IFRS.

BC47J The Board understands that most first-time adopters with operations subject to rate regulation have previously accounted for property, plant and equipment largely in accordance with a historical cost model consistent with IAS 16. The Board concluded that the cost and effort required to achieve total compliance in this area for the purposes of preparing an entity's first IFRS financial statements is not warranted to meet the objective of providing a suitable starting point for accounting under IFRSs. IFRS 1 requires that each item for which the exemption is used is tested for impairment, either individually or at the cash-generating unit to which the item belongs in accordance with IAS 36, at the date of transition. This requirement provides further assurance that this objective is met.

BC47K Consistent with the Board's rationale for the use of fair value as deemed cost in paragraphs BC43 and BC44, this exemption means that an entity will report the same cost data as if it had acquired an asset with the same remaining service potential for that amount at the date of transition to IFRSs. An entity's use of this exemption results in a new cost basis for the item and previous GAAP depreciation methods and capitalisation policies are not relevant. Thus, if an entity uses this exemption for items of property, plant and equipment or intangible assets, it does not also apply the exemption for borrowing costs provided in paragraph D23.

Employee benefits

BC48 [Deleted]~~If an entity elects to use the 'corridor' approach in IAS 19 *Employee Benefits*, full retrospective application of IAS 19 would require the entity to determine actuarial gains or losses for each year since the inception of the plan in order to determine the net cumulative unrecognised gains or losses at the date of transition to IFRSs. The Board concluded that this would not benefit users and would be costly. Therefore, the IFRS permits a first-time adopter to recognise all actuarial gains or losses up to the date of transition to IFRSs, even if its accounting policy in accordance with IAS 19 involves leaving some later actuarial gains and losses unrecognised (paragraph D10 of the IFRS).~~

BC49 The revision of IAS 19 in 1998 increased the reported employee benefit liabilities of some entities. IAS 19 permitted entities to amortise that increase over up to five years. Some suggested a similar transitional treatment for first-time adopters. However, the Board has no general policy of exempting transactions occurring before a specific date from the requirements of new IFRSs (paragraph 21* of the *Preface to International Financial Reporting Standards*). Therefore, the Board did not include a similar transitional provision for first-time adopters.

BC50 An entity's first IFRS financial statements may reflect measurements of pension liabilities at three dates: the reporting date, the end of the comparative year and the date of transition to IFRSs. Some suggested that obtaining three separate actuarial valuations for a single set of financial statements would be costly. Therefore, they proposed that the Board should permit an entity to use a single actuarial valuation, based, for example, on assumptions valid at the reporting date, with service costs and interest costs based on those assumptions for each of the periods presented.

BC51 However, the Board concluded that a general exemption from the principle of measurement at each date would conflict with the objective of providing understandable, relevant, reliable and comparable information for users. If an entity obtains a full actuarial valuation at one or two of these dates and rolls that (those) valuation(s) forward or back to the other date(s), any such roll forward or roll back needs to reflect material transactions and other material events (including changes in market prices and interest rates) between those dates (IAS 19 paragraph 57).

BC52 [Deleted]~~Some suggested that the Board should exempt a first-time adopter from the requirement to identify and amortise the unvested portion of past service cost at the date of transition to IFRSs. However, this requirement is less onerous than the retrospective application of the corridor for actuarial gains and losses because it does not require the recreation of data since the inception of the plan. The Board concluded that no exemption was justified for past service cost.~~

Cumulative translation differences

BC53 IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to classify some cumulative translation differences (CTDs) relating to a net investment in a foreign operation as a separate component of equity. The entity transfers the CTDs to the income statement on subsequent disposal of the foreign operation. The proposals in ED 1 would have permitted a first-time adopter to use the CTDs in accordance with previous GAAP as the deemed CTDs in accordance with IFRSs if reconstructing CTDs would have involved undue cost or effort.

* amended to paragraph 20 when the *Preface* was revised in January 2010.

BC54 Some respondents to ED 1 argued that it would be more transparent and comparable to exempt an entity from the requirement to identify CTDs at the date of transition to IFRSs, for the following reasons:

(a) An entity might know the aggregate CTDs, but might not know the amount for each subsidiary. If so, it could not transfer that amount to the income statement on disposal of that subsidiary. This would defeat the objective of identifying CTDs as a separate component of equity.

(b) The amount of CTDs in accordance with previous GAAP might be inappropriate as it might be affected by adjustments made on transition to IFRSs to assets and liabilities of foreign entities.

BC55 The Board found these arguments persuasive. Therefore, a first-time adopter need not identify the CTDs at the date of transition to IFRSs (paragraphs D12 and D13 of the IFRS). The first-time adopter need not show that identifying the CTDs would involve undue cost or effort.

Compound financial instruments

BC56 IAS 32 requires an entity to split a compound financial instrument at inception into separate liability and equity components. Even if the liability component is no longer outstanding, retrospective application of IAS 32 would involve separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component of the instrument.

BC57 Some respondents to ED 1 argued that separating these two portions would be costly if the liability component of the compound instrument is no longer outstanding at the date of transition to IFRSs. The Board agreed with those comments. Therefore, if the liability component is no longer outstanding at the date of transition to IFRSs, a first-time adopter need not separate the cumulative interest on the liability component from the equity component (paragraph D18 of the IFRS).

BC58 Some respondents requested an exemption for compound instruments even if still outstanding at the date of transition to IFRSs. One possible approach would be to use the fair value of the components at the date of transition to IFRSs as deemed cost. However, as the IFRS does not include any exemptions for financial liabilities, the Board concluded that it would be inconsistent to create such an exemption for the liability component of a compound instrument.

Investments in subsidiaries, jointly controlled entities[*] and associates

BC58A IAS 27 *Consolidated and Separate Financial Statements* requires an entity, in its separate financial statements, to account for investments in subsidiaries, jointly controlled entities[*] and associates either at cost or in accordance with IAS 39.[#] For those investments that are measured at cost, the previous version of IAS 27 (before *Cost of an Investment* in a *Subsidiary, Jointly Controlled Entity or Associate* was issued in May 2008) required an entity to recognise income from the investment only to the extent the entity received distributions from post-acquisition retained earnings (the ‘cost method’). Distributions received in excess of such profits were regarded as a recovery of investment and were recognised as a reduction in the cost of the investment.

BC58B For some jurisdictions, these aspects of IAS 27 led to practical difficulties on transition to IFRSs. In order to apply IAS 27 retrospectively, it would be necessary:

(a) to measure the fair value of the consideration given at the date of acquisition; and

(b) to determine whether any dividends received from a subsidiary after its acquisition were paid out of pre-acquisition retained earnings, which would reduce the carrying amount of the investment in the subsidiary in the parent’s separate financial statements.

[*] 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

[#] The consolidation guidance was removed from IAS 27 and the Standard was renamed *Separate Financial Statements* by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The accounting requirements for separate financial statements were not changed.

BC58C If a parent held an investment in a subsidiary for many years, such an exercise might be difficult, or even impossible, and perhaps costly. For example, in some jurisdictions, entities accounted for some previous acquisitions that were share-for-share exchanges using so-called 'merger relief' or 'group reconstruction relief'. In this situation, the carrying amount of the investment in the parent's separate financial statements was based on the nominal value of the shares given rather than the value of the purchase consideration. This might make it difficult or impossible to measure the fair value of the shares given.

BC58D The Board published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1, in January 2007. In response to the issues outlined in paragraphs BC58A–BC58C, the Board proposed two exemptions from applying the requirements of IAS 27 retrospectively upon first-time adoption of IFRSs:

(a) an alternative approach for determining the cost of an investment in a subsidiary in the separate financial statements of a parent; and

(b) simplification of the process for determining the pre-acquisition retained earnings of that subsidiary.

BC58E In developing that exposure draft, the Board considered three ways of determining a deemed cost of an investment in a subsidiary at the parent's date of transition to IFRSs in its separate financial statements. These were:

(a) the previous GAAP cost of the investment (previous GAAP deemed cost).

(b) the parent's interest in the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's statement of financial position (net asset deemed cost).

(c) the fair value of the investment (fair value deemed cost).

BC58F The Board decided that the net asset deemed cost option would provide relevant information to users about the subsidiary's financial position at the date of transition to IFRSs and would be relatively easy to determine. The fair value deemed cost option would provide relevant information at the date of transition to IFRSs, but might be more costly and difficult to determine.

BC58G In some situations, the cost of an investment in a subsidiary determined using the previous GAAP carrying amount might bear little resemblance to cost determined in accordance with IAS 27. Therefore, the Board rejected the use of a deemed cost based on the previous GAAP carrying amount. The Board proposed to allow entities a choice between the net asset deemed cost and the fair value deemed cost.

BC58H Respondents to the exposure draft stated that the previous GAAP carrying amount is a more appropriate deemed cost. They argued that:

(a) a net asset deemed cost would not include goodwill or other intangible assets that might be present in a carrying amount determined in accordance with previous GAAP. When this is the case, the net asset deemed cost option would understate the assets of the entities for which it is used. The resulting reduction in the carrying amount of the investment could reduce the distributable profits of the parent.

(b) it was difficult to see why, in the light of the exemption in IFRS 1 from applying IFRS 3 retrospectively, the Board did not propose to permit the cost of the investment in a subsidiary in accordance with previous GAAP to be used as a deemed cost. When an entity had chosen not to apply IFRS 3 retrospectively to a past business combination, it would be logical not to require it to restate the cost of the related investment in the separate financial statements of the parent.

BC58I In the light of respondents' comments, the Board observed that, in many instances, neither the previous GAAP carrying amount nor the net asset deemed cost represents 'cost'—both numbers could be viewed as being equally arbitrary.

BC58J In order to reduce the cost of adopting IFRSs in the parent entity's separate financial statements without significantly reducing the benefits of those statements, the Board decided to allow entities a choice between the previous GAAP carrying amount and the fair value as deemed cost.

BC58K The Board also agreed with respondents that similar issues arise for investments in associates and jointly controlled entities.[†] As a result, paragraph D15 of the IFRS applies to such investments.

BC58L The Board published its revised proposals in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*, an exposure draft of proposed amendments to IFRS 1 and IAS 27, in December 2007. Respondents generally supported the proposed amendments to IFRS 1. The Board included the amendments in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* issued in May 2008.

BC58M In developing the December 2007 exposure draft, the Board decided to address the simplification of the process for determining the pre-acquisition retained earnings of a subsidiary more generally through an amendment to IAS 27 (see paragraph 38A of IAS 27 and paragraphs BC66D–BC66J[#] of the Basis for Conclusions on IAS 27).

Assets and liabilities of subsidiaries, associates and joint ventures

BC59 A subsidiary may have reported to its parent in the previous period using IFRSs without presenting a full set of financial statements in accordance with IFRSs. If the subsidiary subsequently begins to present financial statements that contain an explicit and unreserved statement of compliance with IFRSs, it becomes a first-time adopter at that time. This might compel the subsidiary to keep two parallel sets of accounting records based on different dates of transition to IFRSs, because some measurements in accordance with the IFRS depend on the date of transition to IFRSs.

BC60 In developing ED 1, the Board concluded that a requirement to keep two parallel sets of records would be burdensome and not be beneficial to users. Therefore, ED 1 proposed that a subsidiary would not be treated as a first-time adopter for recognition and measurement purposes if the subsidiary was consolidated in IFRS financial statements for the previous period and all owners of the minority interests consented.[*]

BC61 Some respondents to ED 1 opposed the exemption, on the following grounds:

(a) The exemption would not eliminate all differences between the group reporting package and the subsidiary's own financial statements. The reporting package does not constitute a full set of financial statements, the parent may have made adjustments to the reported numbers (for example, if pension cost adjustments were made centrally), and the group materiality threshold may be higher than for the subsidiary.

(b) The Board's objective of comparability between different entities adopting IFRSs for the first time at the same date (paragraph BC10) should apply equally to any entity, including subsidiaries, particularly if the subsidiary's debt or equity securities are publicly traded.

BC62 However, the Board retained the exemption because it will ease some practical problems. Although the exemption does not eliminate all differences between the subsidiary's financial statements and a group reporting package, it does reduce them. Furthermore, the exemption does not diminish the relevance and reliability of the subsidiary's financial statements because it permits a measurement that is already acceptable in accordance with IFRSs in the consolidated financial statements of the parent. Therefore, the Board also eliminated the proposal in ED 1 that the exemption should be conditional on the consent of minorities.

† 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issied in May 2011, replaced IAS 31 and changed the terminology.

renumbered to paragraphs 12 and BC16-BC22 when IAS 27 was amended in May 2011.

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

BC63 In finalising the IFRS, the Board simplified the description of the exemption for a subsidiary that adopts IFRSs after its parent. In accordance with the IFRS, the subsidiary may measure its assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary. Alternatively, it may elect to measure them at the carrying amounts required by the rest of the IFRS, based on the subsidiary's date of transition to IFRSs. The Board also extended the exemption to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it (paragraph D16 of the IFRS). However, if a parent adopts IFRSs later than a subsidiary, the parent cannot, in its consolidated financial statements, elect to change IFRS measurements that the subsidiary has already used in its financial statements, except to adjust for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (paragraph D17 of the IFRS).

Designation of previously recognised financial instruments

BC63A IAS 39 permits an entity to designate, on initial recognition only, a financial instrument as (a) available for sale (for a financial asset) or (b) a financial asset or financial liability at fair value through profit or loss (provided the asset or liability qualifies for such designation in accordance with paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39). Despite this requirement, an entity that had already applied IFRSs before the effective date of IAS 39 (as revised in March 2004) may (a) designate a previously recognised financial asset as available for sale on initial application of IAS 39 (as revised in March 2004), or (b) designate a previously recognised financial instrument as at fair value through profit or loss in the circumstances specified in paragraph 105B of IAS 39. The Board decided that the same considerations apply to first-time adopters as to entities that already apply IFRSs. Accordingly, a first-time adopter of IFRSs may similarly designate a previously recognised financial instrument in accordance with paragraph D19 of the IFRS. Such an entity shall disclose the fair value of the financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

Share-based payment transactions

BC63B IFRS 2 *Share-based Payment* contains various transitional provisions. For example, for equity-settled share-based payment arrangements, IFRS 2 requires an entity to apply IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not vested at the effective date of IFRS 2. IFRS 2 is effective for annual periods beginning on or after 1 January 2005. There are also transitional arrangements for liabilities arising from cash-settled share-based payment transactions, and for modifications of the terms or conditions of a grant of equity instruments to which IFRS 2 has not been applied, if the modification occurs after the effective date of IFRS 2. The Board decided that, in general, first-time adopters should be treated in the same way as entities that already apply IFRSs. For example, a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted on or before 7 November 2002. Similarly, a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted after 7 November 2002 if those equity instruments vested before 1 January 2005. In addition, the Board decided that a first-time adopter should not be required to apply IFRS 2 to equity instruments that were granted after 7 November 2002 if those equity instruments vested before the date of transition to IFRSs. Similarly, the Board decided that a first-time adopter should not be required to apply IFRS 2 to liabilities arising from cash-settled share-based payment transactions if those liabilities were settled before the date of transition to IFRSs.

Changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment

BC63C IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in decommissioning, restoration and similar liabilities to be added to, or deducted from, the cost of the assets to which they relate, and the adjusted depreciable amount to be depreciated prospectively over the remaining useful life of those assets. Retrospective application of this requirement at the date of transition would require an entity to construct a historical record of all such adjustments that would have been made in the past. In many cases this will not be practicable. The Board agreed that, as an alternative to complying with this requirement, an entity should be permitted to include in the depreciated cost of the asset, at the date of transition to IFRSs, an amount calculated by discounting the liability at that date back to, and depreciating it from, when the liability was first incurred.

BC63CA Paragraph D21 of the IFRS exempts from the requirements of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* changes in decommissioning costs incurred before the date of transition to IFRSs. Use of this exemption would require detailed calculations that would not be practicable for entities that used the method of accounting described in paragraph BC47A under their previous GAAP. The Board noted that adjustments to liabilities as a result of initial adoption of IFRSs arise from events and transactions before the date of transition to IFRSs and are generally recognised in retained earnings. Therefore, the Board decided that, for entities that used the method of accounting described in paragraph BC47A, any adjustment for a difference between decommissioning, restoration and similar liabilities measured in accordance with IAS 37 and the liability determined under the entity's previous GAAP should be accounted for in the same manner.

Leases

BC63D IFRIC 4 *Determining whether an Arrangement contains a Lease* contains transitional provisions because the IFRIC acknowledged the practical difficulties raised by full retrospective application of the Interpretation, in particular the difficulty of going back potentially many years and making a meaningful assessment of whether the arrangement satisfied the criteria at that time. The Board decided to treat first-time adopters in the same way as entities that already apply IFRSs.

BC63DA IFRIC 4 permits an entity to apply its requirements to arrangements existing at the start of the earliest period for which comparative information is presented on the basis of facts and circumstances existing at the start of that period. Before adopting IFRSs, a jurisdiction might adopt a national standard having the same effect as the requirements of IFRIC 4, including the same transitional provisions. An entity in that jurisdiction might then apply requirements having the same effect as the requirements of IFRIC 4 to some or all arrangements (even if the wording of those requirements is not identical). However, the entity might apply the requirements at a date different from the date in the transitional provisions of IFRIC 4. IFRS 1 would require such an entity to reassess that accounting retrospectively on first-time adoption. This might result in additional costs, with no obvious benefits. Accordingly, the Board decided that if a first-time adopter made the same determination under previous GAAP as that required by IFRIC 4 but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRSs.

BC63DB The Board considered a more general modification to IFRS 1. It considered whether to modify IFRS 1 so that entities need not reassess, at the date of transition to IFRSs, prior accounting if that prior accounting permitted the same prospective application as IFRSs with the only difference from IFRSs being the effective date from when that accounting was applied. In this regard, the Board noted that any such proposal must apply to assessments resulting in the *same* determination, rather than *similar* determinations, because it would be too difficult to determine and enforce what constitutes a sufficient degree of similarity. The Board noted that many of the circumstances in which this situation might arise have been dealt with in IFRS 1 or other IFRSs. Accordingly, the Board decided to focus on IFRIC 4 only.

Borrowing costs

BC63E IAS 23 *Borrowing Costs* (as revised in 2007) contains transitional provisions because the Board acknowledged that if an entity has been following the accounting policy of immediately recognising borrowing costs as an expense and has not previously gathered the necessary information for capitalisation of borrowing costs, getting the information retrospectively may be costly. First-time adopters of IFRSs face problems similar to those facing entities that already apply IFRSs. Moreover, although first-time adopters have the option of using fair value as the deemed cost of an asset at the date of transition to IFRSs, this option is not applicable to all qualifying assets, such as inventories. Furthermore, the Board concluded that the existence of the deemed cost option is not sufficient to justify a more stringent requirement for the application of IAS 23 for first-time adopters than for entities that already apply IFRSs. A more stringent requirement for the adoption of the capitalisation treatment could be justified when IFRS 1 was originally issued because capitalisation was then an option. The requirements for the application of mandatory capitalisation, on the other hand, should be the same for entities that already apply IFRSs and for first-time adopters. Therefore, the Board decided to amend IFRS 1, allowing first-time adopters transitional provisions equivalent to those available to entities that already apply IFRSs in paragraphs 27 and 28 of IAS 23, as revised in 2007.

BC63EA In *Annual Improvements 2009–2011 Cycle* (issued in May 2012) the Board addressed some concerns that were raised by first-time adopters about the transitional provisions for borrowing costs relating to qualifying assets for which the commencement date for capitalisation was before the date of transition to IFRSs. Interested parties found it unclear whether borrowing costs capitalised in accordance with previous GAAP should be retained, restated or eliminated in the opening statement of financial position. Interested parties also questioned the accounting, after the date of transition, for borrowing costs that relate to such qualifying assets when these qualifying assets are under construction at the date of transition. They wanted clarification as to whether the first-time adopter should apply the requirements of IAS 23 *Borrowing Costs* or whether it should continue applying its previous GAAP even if that previous GAAP is not consistent with IAS 23.

BC63EB The Board clarified that when the entity chooses to apply the exemption in paragraph D23 of IFRS 1, the borrowing costs that were capitalised in accordance with previous GAAP should be carried forward in the opening statement of financial position. This is because gathering the information for capitalisation of borrowing costs under IAS 23 and identifying and eliminating the amounts (if any) capitalised in past years under previous GAAP may be costly. In addition, the Board clarified that an entity should account for borrowing costs that are incurred after the date of transition and that relate to qualifying assets under construction at the date of transition in accordance with IAS 23, regardless of whether the entity capitalised or recognised in profit and loss borrowing costs under previous GAAP. The Board determined that this requirement would ensure useful information to users of financial statements. A first-time adopter could also choose to apply the requirements of IAS 23 from a date earlier than the date of transition, in which case it should account for borrowing costs in accordance with IAS 23 on or after the earlier date selected.

Severe hyperinflation

BC63F In 2010 the Board was asked to clarify how an entity should resume presenting financial statements in accordance with IFRSs after a period of severe hyperinflation, during which the entity had been unable to comply with IAS 29 *Financial Reporting in Hyperinflationary Economies*. An entity would be unable to comply with IAS 29 if a reliable general price index is not available to all entities with that same functional currency, and exchangeability between the currency and a relatively stable foreign currency does not exist. However, once the functional currency changes to a non-hyperinflationary currency, or the currency ceases to be severely hyperinflationary, an entity would be able to start applying IFRSs to subsequent transactions.

BC63G The Board noted that IFRSs did not provide sufficient guidance in these circumstances. The Board therefore decided to amend IFRS 1 to provide guidance on how an entity can present IFRS financial statements after its currency ceases to be severely hyperinflationary, by presenting an opening IFRS statement of financial position on or after the functional currency normalisation date. The Board believed that allowing an entity to apply the exemption when presenting an opening IFRS statement of financial position after, and not just on, the functional currency normalisation date, would address practical concerns that may arise if the functional currency normalisation date and the entity's date of transition to IFRSs are different. The Board decided that this amendment would also be available to entities that were emerging from a period of severe hyperinflation but had not applied IFRSs in the past.

BC63H The Board decided to permit an entity emerging from a period of severe hyperinflation to elect to measure its assets and liabilities at fair value. That fair value could then be used as the deemed cost in its opening IFRS statement of financial position. The Board believed that this approach would expand the scope of the deemed cost exemptions in IFRS 1 to enable them to be applied in these specific circumstances. However, because severe hyperinflation is a specific set of circumstances, the Board wanted to ensure that the fair value measurement option was applied only to those assets and liabilities that were held before the functional currency normalisation date, and not to other assets and liabilities held by the entity at the time it made the transition to IFRSs. Furthermore, where a parent entity's functional currency has been subject to severe hyperinflation, but its subsidiary company's functional currency has not been subject to severe hyperinflation, the Board decided it was inappropriate for such a subsidiary company to be able to apply this exemption.

BC63I The Board decided that any adjustments arising on electing to measure assets and liabilities at fair value in the opening IFRS statement of financial position arise from events and transactions before the date of transition to IFRSs. Consequently, those adjustments should be accounted for in accordance with paragraph 11 of IFRS 1, and an entity should recognise those adjustments directly in retained earnings (or, if appropriate, in another category of equity) at the date of transition to IFRSs.

BC63J The Board observed that entities are required to apply paragraph 21 of IFRS 1 and prepare and present comparative information in accordance with IFRSs. The Board noted that preparation of information in accordance with IFRSs for periods before the functional currency normalisation date may not be possible; hence the exemption refers to a date of transition on or after the functional currency normalisation date. This may lead to a comparative period of less than 12 months. The Board identified that entities should consider whether disclosure of non-IFRS comparative information and historical summaries, in accordance with paragraph 22 of IFRS 1, would provide useful information to users of financial statements. The Board also noted that an entity should clearly explain the transition to IFRSs in accordance with paragraphs 23–28.

Joint arrangements

BC63K During its redeliberation of the exposure draft ED 9 *Joint Arrangements* the Board decided not to require entities changing from proportionate consolidation to the equity method to adjust any differences between the two accounting methods retrospectively. Instead an entity should determine the opening balance of the investment relating to its interest in a joint venture as the aggregate of the carrying amounts of the assets and liabilities that the entity had been previously proportionately consolidated, including any goodwill arising from acquisition as at the beginning of the earliest period presented. The Board decided to treat first-time adopters in the same way as entities that already apply IFRSs with the following exception.

BC63L A first-time adopter is required to test for impairment the opening investment in accordance with IAS 36 at the earliest period presented, regardless of whether there is any indication that the investment may be impaired. The Board noted that this is a more stringent requirement for the application of IFRS 11 *Joint Arrangements* by first-time adopters, but is aligned with the requirement for first-time adopters to apply IAS 36 in testing goodwill for impairment at the date of transition to IFRSs regardless of whether there is any indication that the goodwill may be impaired.

BC63M *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to IFRS 10, IFRS 11 and IFRS 12), issued in June 2012, amended IFRS 11 to require the transition adjustments of that IFRS to be recognised at the beginning of the annual period immediately preceding the first annual period for which IFRS 11 is applied (the 'immediately preceding period') instead of the beginning of the earliest period presented. The Board agreed that IFRS 1 should not be amended to reflect those amendments because the adjustments required on transition to IFRS should be reflected at the date of transition, which may be earlier than the beginning of the immediately preceding period. Consequently, paragraph D31 was amended to clarify that, when a first-time adopter is applying the transition guidance of IFRS 11, they shall apply the requirements at the date of transition, which is the same as the beginning of the earliest IFRS period presented.

Other possible exemptions rejected

BC64 The Board considered and rejected suggestions for other exemptions. Each such exemption would have moved the IFRS away from a principle-based approach, diminished transparency for users, decreased comparability over time within an entity's first IFRS financial statements and created additional complexity. In the Board's view, any cost savings generated would not have outweighed these disadvantages. Paragraphs BC65–BC73 discuss some of the specific suggestions the Board considered for embedded derivatives, hyperinflation, intangible assets and transaction costs on financial instruments.

Embedded derivatives

BC65 IAS 39 requires an entity to account separately for some embedded derivatives at fair value. Some respondents to ED 1 argued that retrospective application of this requirement would be costly. Some suggested either an exemption from retrospective application of this requirement, or a requirement or option to use the fair value of the host instrument at the date of transition to IFRSs as its deemed cost at that date.

BC66 The Board noted that US GAAP provides an option in this area. Under the transitional provisions of SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*, an entity need not account separately for some pre-existing embedded derivatives. Nevertheless, the Board concluded that the failure to measure embedded derivatives at fair value would diminish the relevance and reliability of an entity's first IFRS financial statements. The Board also observed that IAS 39 addresses an inability to measure an embedded derivative and the host contract separately. In such cases, IAS 39 requires an entity to measure the entire combined contract at fair value.

Hyperinflation

BC67 Some argued that the cost of restating financial statements for the effects of hyperinflation in periods before the date of transition to IFRSs would exceed the benefits, particularly if the currency is no longer hyperinflationary. However, the Board concluded that such restatement should be required, because hyperinflation can make unadjusted financial statements meaningless or misleading.

Intangible assets

BC68 For the following reasons, some proposed that a first-time adopter's opening IFRS balance sheet should exclude intangible assets that it did not recognise in accordance with previous GAAP:

(a) Using hindsight to assess retrospectively when the recognition criteria for intangible assets were met could be subjective, open up possibilities for manipulation and involve costs that might exceed the benefits to users.

(b) The benefits expected from intangible assets are often not related directly to the costs incurred. Therefore, capitalising the costs incurred is of limited benefit to users, particularly if the costs were incurred in the distant past.

(c) Such an exclusion would be consistent with the transitional provisions in IAS 38 *Intangible Assets*. These encourage (but do not require) the recognition of intangible assets acquired in a previous business combination that was an acquisition and prohibit the recognition of all other previously unrecognised intangible assets.

BC69 In many cases, internally generated intangible assets do not qualify for recognition in accordance with IAS 38 at the date of transition to IFRSs because an entity did not, in accordance with previous GAAP, accumulate cost information or did not carry out contemporaneous assessments of future economic benefits. In these cases, there is no need for a specific requirement to exclude those assets. Furthermore, when these assets do not qualify for recognition, first-time adopters will not generally, in the Board's view, need to perform extensive work to reach this conclusion.

BC70 In other cases, an entity may have accumulated and retained sufficient information about costs and future economic benefits to determine which intangible assets (whether internally generated or acquired in a business combination or separately) qualify in accordance with IAS 38 for recognition in its opening IFRS balance sheet. If that information is available, no exclusion is justified.

BC71 Some argued that fair value should be used as deemed cost for intangible assets in the opening IFRS balance sheet (by analogy with a business combination). ED 1 would not have permitted this. However, in finalising the IFRS, the Board concluded that this approach should be available for those intangible assets for which IFRSs already permit fair value measurements. Therefore, in accordance with the IFRS, a first-time adopter may elect to use fair value or some previous GAAP revaluations of intangible assets as deemed cost for IFRSs, but only if the intangible assets meet:

(a) the recognition criteria in IAS 38 (including reliable measurement of original cost); and

(b) the criteria in IAS 38 for revaluation (including the existence of an active market) (paragraph D7 of the IFRS).

Transaction costs: financial instruments

BC72 To determine the amortised cost of a financial asset or financial liability using the effective interest method, it is necessary to determine the transaction costs incurred when the asset or liability was originated. Some respondents to ED 1 argued that determining these transaction costs could involve undue cost or effort for financial assets or financial liabilities originated long before the date of transition to IFRSs. They suggested that the Board should permit a first-time adopter:

(a) to use the fair value of the financial asset or financial liability at the date of transition to IFRSs as its deemed cost at that date; or

(b) to determine amortised cost without considering transaction costs.

BC73 In the Board's view, the unamortised portion of transaction costs at the date of transition to IFRSs is unlikely to be material for most financial assets and financial liabilities. Even when the unamortised portion is material, reasonable estimates should be possible. Therefore, the Board created no exemption in this area.

Retrospective designation

BC74 The Board considered practical implementation difficulties that could arise from the retrospective application of aspects of IAS 39:

(a) hedge accounting (paragraphs BC75–BC80);

(b) government loans (paragraphs BC80A–BC80E);

~~(b)~~(c) the treatment of cumulative fair value changes on available-for-sale financial assets at the date of transition to IFRSs (paragraphs BC81–BC83); and

~~(c)~~(d) 'day 1' gain or loss recognition (paragraph BC83A).

Hedge accounting

BC75 Before beginning their preparations for adopting IAS 39 (or a local standard based on IAS 39), it is unlikely that most entities would have adopted IAS 39's criteria for (a) documenting hedges at their inception and (b) testing the hedges for effectiveness, even if they intended to continue the same hedging strategies after adopting IAS 39. Furthermore, retrospective designation of hedges (or retrospective reversal of their designation) could lead to selective designation of some hedges to report a particular result.

BC76 To overcome these problems, the transitional requirements in IAS 39 require an entity already applying IFRSs to apply the hedging requirements prospectively when it adopts IAS 39. As the same problems arise for a first-time adopter, the IFRS requires prospective application by a first-time adopter.

BC77 ED 1 included a redrafted version of the transitional provisions in IAS 39 and related *Questions and Answers* (Q&As) developed by the IAS 39 Implementation Guidance Committee. The Board confirmed in the Basis for Conclusions published with ED 1 that it did not intend the redrafting to create substantive changes. However, in the light of responses to ED 1, the Board decided in finalising IFRS 1 that the redrafting would not make it easier for first-time adopters and others to understand and apply the transitional provisions and Q&As. However, the project to improve IAS 32 and IAS 39 resulted in certain amendments to the transition requirements. In addition, this project incorporated selected other Q&As (ie not on transition) into IAS 39. The Board therefore took this opportunity to consolidate all the guidance for first-time adopters in one place, by incorporating the Q&As on transition into IFRS 1.

BC78 Some respondents to ED 1 asked the Board to clarify what would happen if hedge accounting in accordance with previous GAAP involved hedging relationships of a type that does not qualify for hedge accounting in accordance with IAS 39. The problem can be seen most clearly for a hedge of a net position (macro hedge). If a first-time adopter were to use hedge accounting in its opening IFRS balance sheet for a hedge of a net position, this would involve either:

(a) recognising deferred debits and credits that are not assets and liabilities (for a fair value hedge); or

(b) deferring gains or losses in equity when there is, at best, a weak link to an underlying item that defines when they should be transferred to the income statement (for a cash flow hedge).

BC79 As either of these treatments would diminish the relevance and reliability of an entity's first IFRS financial statements, the Board decided that an entity should not apply hedge accounting in its opening IFRS balance sheet to a hedge of a net position that does not qualify as a hedged item in accordance with IAS 39. However, the Board concluded that it would be reasonable (and consistent with IAS 39 paragraph 133[*]) to permit a first-time adopter to designate an individual item as a hedged item within the net position, provided that it does so no later than the date of transition to IFRSs, to prevent selective designation. For similar reasons, the Board prohibited hedge accounting in the opening IFRS balance sheet for any hedging relationship of a type that does not qualify for hedge accounting in accordance with IAS 39 (see paragraph B5 of the IFRS).

BC80 Some respondents to ED 1 suggested that an entity adopting IFRSs for the first time in 2005 could not meet IAS 39's documentation and effectiveness criteria by the date of transition to IFRSs (1 January 2004 for many entities). Some requested an exemption from these criteria until the beginning of the latest period covered by the first IFRS financial statements (1 January 2005 for many entities). However, for the following reasons, the Board did not create an exemption in this area:

(a) The Board's primary objective is comparability within a first-time adopter's first IFRS financial statements and between different first-time adopters switching to IFRSs at the same time (paragraph BC10).

(b) The continuation of previous GAAP hedge accounting practices could permit the non-recognition of derivatives or the recognition of deferred debits and credits that are not assets and liabilities.

(c) The Board's benchmark for cost-benefit assessments was an entity that has planned the transition to IFRSs and is able to collect the necessary information at, or very soon after, the date of transition to IFRSs (paragraph BC27). Entities should not be 'rewarded'

[*] In IAS 39, as revised in 2003, paragraph 133 was replaced by paragraphs 84 and AG101.

by concessions if they failed to plan for transition, nor should that failure be allowed to undermine the integrity of their opening IFRS balance sheet. Entities switching to IFRSs in 2005 need to have their hedge accounting systems in place by the beginning of 2004. In the Board's view, that is a challenging but achievable timetable. Entities preparing to switch to IFRSs in 2004 should have been aware of the implications of IAS 39 already and the exposure draft of improvements to IAS 39, published in June 2002, proposed very few changes in this area, so delayed transition is not justified for these entities either.

Government loans

BC80A IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (as revised in May 2008) introduced a requirement that government loans with a below-market rate of interest shall be measured at fair value on initial recognition. At the time this requirement was added, the Board recognised that applying it retrospectively may require entities to measure the fair value of loans at an earlier date. Accordingly, the Board decided that entities should apply this requirement in IAS 20 prospectively, with earlier application permitted.

BC80B In 2011 the application of this requirement by first-time adopters was brought to the Board's attention. The Board noted that the general requirement in IFRS 1 for first-time adopters to apply IFRSs retrospectively at the date of transition to IFRSs could require some entities to measure such government loans at fair value at a date before the date of transition to IFRSs. This may lead to an entity applying hindsight if it must derive a fair value that needs significant unobservable inputs. Accordingly, the Board decided to add an exception to the retrospective application of IFRSs to require that first-time adopters shall apply the requirements of IAS 20 prospectively to government loans existing at the date of transition to IFRSs, unless the necessary information was obtained at the time of initially accounting for that loan. As a result of not applying IAS 20 and IFRS 9 retrospectively to government loans at the date of transition, the corresponding benefit of the government loan at a below-market rate of interest is not recognised as a government grant.

BC80C The Board proposed the exception in October 2011 in the exposure draft *Government Loans* (proposed amendments to IFRS 1). In recognition of comments on the exposure draft, the Board revised paragraph B10 to specify that an entity applies IAS 32 *Financial Instruments: Presentation* to classify the government loans as a financial liability or an equity instrument, and to limit the scope of the exemption to matters of recognition and measurement. This will give first-time adopters the same relief as existing preparers and will mean that if a first-time adopter had classified government loans in equity under its previous GAAP, it will reclassify those loans as liabilities, if those loans meet the definition of a financial liability in IAS 32. The Board also clarified that an entity should use its previous GAAP carrying amount of such loans at the date of transition to IFRSs as the carrying amount in the opening IFRS statement of financial position. IFRS 9 should be applied to such loans subsequently.

BC80D Some respondents to the exposure draft asked why the retrospective application of IAS 20 should be optional, rather than mandatory, if the information needed to apply IFRS 9 had been obtained. The Board thought that mandatory restatement could require an onerous search to determine whether this information had been obtained when initially accounting for loans that were received many years ago.

BC80E The Board noted that prohibiting the application of this option on a loan-by-loan basis might introduce further complexity into IFRS 1. This is because it may raise further questions, such as whether the retrospective application would be permitted for all the loans for which the information needed was obtained at the time, even if there are other similar loans for which the fair value information was not obtained at that time; and whether the retrospective application should be restricted to all loans received after a certain date and for which all necessary information was obtained to enable retrospective application. The Board concluded that the exception proposed in paragraph B11 should be available on a loan-by-loan basis.

Available-for-sale financial assets

BC81 Retrospective application of IAS 39 to available-for-sale financial assets requires a first-time adopter to recognise the cumulative fair value changes in a separate component of equity in the opening IFRS balance sheet, and transfer those fair value changes to the income statement on subsequent disposal or impairment of the asset. This could allow, for example, selective classification of assets with cumulative gains as available for sale (with subsequent transfers to the income statement on disposal) and assets with cumulative losses as held for trading (with no transfers on disposal).

BC82 IAS 39 confirmed the proposal in the exposure draft of June 2002 to give an entity that already applies IFRSs an option to designate any financial asset as at fair value through profit or loss when it first applies the proposed improvements. Although this requirement could increase the risk of selective classification by first-time adopters of the kind discussed in the previous paragraph, the Board noted that an entity could achieve a similar result by selective disposal of some assets before the date of transition to IFRSs. Therefore, the Board concluded that it should treat first-time adopters in the same way as entities that already apply IFRSs by requiring retrospective application.

BC83 Some respondents to ED 1 commented that the cost of determining the amount to be included in a separate component of equity would exceed the benefits. However, the Board noted that these costs would be minimal if a first-time adopter carried the available-for-sale financial assets in accordance with previous GAAP at cost or the lower of cost and market value. These costs might be more significant if it carried them at fair value, but in that case it might well classify the assets as held for trading. Therefore, the Board made no changes to ED 1's proposal that a first-time adopter should apply IAS 39 retrospectively to available-for-sale financial assets.

BC83A IFRS 1 originally required retrospective application of the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76. After the revised IAS 39 was issued, constituents raised concerns that retrospective application would diverge from the requirements of US GAAP, would be difficult and expensive to implement, and might require subjective assumptions about what was observable and what was not. In response to these concerns, the Board decided to permit entities to apply the requirements in the last sentence of IAS 39 paragraph AG76 and in paragraph AG76A, in any one of the following ways:

(a) retrospectively;

(b) prospectively to transactions entered into after 25 October 2002; or

(c) prospectively to transactions entered into after 1 January 2004.

In 2010 the Board was asked to reconsider whether the fixed dates of 25 October 2002 and 1 January 2004 continued to be appropriate for first-time adopters. Constituents were concerned that, as time passes, these fixed dates become more remote and increasingly less relevant to the financial reports as additional jurisdictions adopt IFRSs. The Board accepted that the cost of reconstructing transactions back in time to 25 October 2002 or 1 January 2004 was likely to outweigh the benefit to be achieved in doing so. It therefore amended the fixed dates included in paragraph D20 of IFRS 1 to permit a first-time adopter to apply the 'day 1' gain or loss recognition requirement in IAS 39 paragraphs AG76 and AG76A prospectively from 'the date of transition to IFRSs'.

Estimates

BC84 An entity will have made estimates in accordance with previous GAAP at the date of transition to IFRSs. Events between that date and the reporting date for the entity's first IFRS financial statements might suggest a need to change those estimates. Some of those events might qualify as adjusting events in accordance with IAS 10 *Events after the Balance Sheet Date*.* However, if the entity made those estimates on a basis consistent with IFRSs, the Board concluded that it would be more helpful to users—and more consistent with IAS 8—to recognise the revision of those estimates as income or expense in the period when the entity made the revision, rather than in preparing the opening IFRS balance sheet (paragraphs 14–17 of the IFRS).

Presentation and disclosure

Comparative information

BC85 IAS 1 requires an entity to disclose comparative information (in accordance with IFRSs) for the previous period. Some suggested that a first-time adopter should disclose comparative information for more than one previous period. For entities that already apply IFRSs, users normally have access to financial statements prepared on a comparable basis for several years. However, this is not the case for a first-time adopter.

BC86 Nevertheless, the Board did not require a first-time adopter to present more comparative information than IAS 1 requires, because such a requirement would impose costs out of proportion to the benefits to users, and increase the risk that preparers might need to make arbitrary assumptions in applying hindsight.

BC87 ED 1 proposed that if the first IFRS financial statements include more than one year of comparative information, the additional comparative information should comply with IFRSs. Some respondents to ED 1 noted that some regulators require entities to prepare more than two years of comparatives. They argued the following:

(a) A requirement to restate two years of comparatives would impose excessive costs and lead to arbitrary restatements that might be biased by hindsight.

(b) Consider an entity adopting IFRSs in 2005 and required by its regulator to give two years of comparatives. Its date of transition to IFRSs would be 1 January 2003—several months before the publication of the IFRS and of the standards resulting from the improvements project. This could contradict the Board's assertion in paragraph BC27 above that most preparers could gather most information they need for their opening IFRS balance sheet at, or soon after, the date of transition to IFRSs.

BC88 In response to these comments, the Board deleted this proposal. Instead, if a first-time adopter elects to give more than one year of comparative information, the additional comparative information need not comply with IFRSs, but the IFRS requires the entity:

(a) to label previous GAAP information prominently as not being prepared in accordance with IFRSs.

(b) to disclose the nature of the main adjustments that would make it comply with IFRSs (paragraph 22 of the IFRS).

* In September 2007 the IASB amended the title of IAS 10 *Events after the Balance Sheet Date* to *Events after the Reporting Period* as a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007.

BC89 Some respondents to ED 1 suggested that it would be onerous to prepare comparative information in accordance with IAS 32 and IAS 39 about financial instruments. They suggested that an entity should be able to apply IAS 39 prospectively from the beginning of the year of its first IFRS financial statements (eg 1 January 2005 for many first-time adopters). They noted that US companies were not required to restate comparatives on the introduction of SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. However, given the Board's emphasis on comparability within the first IFRS financial statements (paragraph BC10) and the assumption of timely planning (paragraph BC27), the Board introduced no general exemption in this area.

BC89A Nevertheless, the Board noted that the revised IAS 32 and IAS 39 were not issued until December 2003. Additionally, the Board's decision to re-expose its proposals for portfolio hedges of interest rate risk had the effect that some of the requirements will not be finalised until early 2004. The Board was sympathetic to concerns that entities that will be required to comply with IFRSs for the first time in 2005 could not make a timely transition to IFRSs because IAS 39 will not be issued in final form until after the start of 2004. Therefore, the Board decided to exempt entities adopting IFRSs for the first time before 1 January 2006 from producing comparative information that complies with IAS 32 and IAS 39, as revised in 2003, in their first IFRS financial statements.

BC89B In the light of respondents' comments on the June 2011 exposure draft *Improvements to IFRSs*, the Board amended paragraph 21 as part of *Annual Improvements 2009–2011 Cycle* (issued in May 2012) because it considered that the requirements for comparative information for a first-time adopter should be different from the requirements for comparative information for an existing preparer. The Board noted that a first-time adopter should not be exempted from presenting three statements of financial position and related notes because it might not have presented this information previously on a basis consistent with IFRSs.

BC89C In addition, the Board considered that a first-time adopter may provide additional comparative information that is presented in accordance with previous GAAP to help the user understand the effects of the transition to IFRSs in accordance with paragraph 22 of IFRS 1. For example, a law or a regulator requires an entity to present the first comparative financial statements in accordance with both IFRSs and previous GAAP and the second comparative in accordance with previous GAAP only. The presentation of this information is an exception from the requirement in paragraph 38C of IAS 1 (to allow an entity to present comparative information in addition to the minimum comparative information required by IFRSs).

Historical summaries

BC90 Some entities choose, or are required, to present in their financial statements historical summaries of selected data covering periods before the first period for which they present full comparative information. Some argued that an entity should present this information in accordance with IFRSs, to ensure comparability over time. However, the Board concluded that such a requirement would cause costs out of proportion to the benefit to users. The IFRS requires disclosure of the nature of the main adjustments needed to make historical summaries included in financial statements or interim financial reports comply with IFRSs (paragraph 22 of the IFRS). Historical summaries published outside financial statements or interim financial reports are beyond the scope of the IFRS.

Explanation of transition to IFRSs

BC91 The IFRS requires disclosures about the effect of the transition from previous GAAP to IFRSs. The Board concluded that such disclosures are essential, in the first (annual) IFRS financial statements as well as in interim financial reports (if any), because they help users understand the effect and implications of the transition to IFRSs and how they need to change their analytical models to make the best use of information presented using IFRSs. The required disclosures relate to both:

(a) the most recent information published in accordance with previous GAAP, so that users have the most up-to-date information; and

(b) the date of transition to IFRSs. This is an important focus of attention for users, preparers and auditors because the opening IFRS balance sheet is the starting point for accounting in accordance with IFRSs.

BC92 Paragraph 24(a) and (b) of the IFRS requires reconciliations of equity and total comprehensive income. The Board concluded that users would also find it helpful to have information about the other adjustments that affect the opening IFRS balance sheet but do not appear in these reconciliations. Because a reconciliation could be voluminous, the IFRS requires disclosure of narrative information about these adjustments, as well as about adjustments to the cash flow statement (paragraph 25 of the IFRS).

BC92A The Board decided to require a first-time adopter to include in its first IFRS financial statements a reconciliation of total comprehensive income (or, if an entity did not report such a total, profit or loss) in accordance with previous GAAP to total comprehensive income in accordance with IFRSs for the latest period reported in accordance with previous GAAP.

BC92B The Board observed that the amendments to IAS 1 in 2007 regarding the presentation of income and expense might result in users having to change their analytical models to include both income and expense that are recognised in profit or loss and those recognised outside profit or loss. Accordingly, the Board concluded that it would be helpful to those users to provide information on the effect and implication of the transition to IFRSs on all items of income and expense, not only those recognised in profit or loss.

BC92C The Board acknowledged that GAAP in other jurisdictions might not have a notion of total comprehensive income. Accordingly, it decided that an entity should reconcile to total comprehensive income in accordance with IFRSs from the previous GAAP equivalent of total comprehensive income. The previous GAAP equivalent might be profit or loss.

BC93 Paragraph 26 of the IFRS states that the reconciliations should distinguish changes in accounting policies from the correction of errors. Some respondents to ED 1 argued that complying with this requirement could be difficult or costly. However, the Board concluded that both components are important and their disclosure should be required because:

(a) information about changes in accounting policies helps explain the transition to IFRSs.

(b) information about errors helps users assess the reliability of financial information. Furthermore, a failure to disclose the effect of material errors would obscure the ‘results of the stewardship of management, or the accountability of management for the resources entrusted to it’ (*Framework*, paragraph 14*).

BC94 For impairment losses (and reversals) recognised in preparing the opening IFRS balance sheet, paragraph 24(c) of the IFRS requires the disclosures that IAS 36 would require if those impairment losses (and reversals) were recognised during the period beginning with the date of transition to IFRSs. The rationale for this requirement is that there is inevitably subjectivity about impairment losses. This disclosure provides transparency about impairment losses recognised on transition to IFRSs. These losses might otherwise receive less attention than impairment losses recognised in earlier or later periods.

BC95 Paragraph 30 of the IFRS requires disclosures about the use of fair value as deemed cost. Although the adjustment arising from the use of this exemption appears in the reconciliations discussed above, this more specific disclosure highlights it. Furthermore, this exemption differs from the other exemptions that might apply for property, plant and equipment (previous GAAP revaluation or event-driven fair value measurement). The latter two exemptions do not lead to a restatement on transition to IFRSs because they apply only if the measurement was already used in previous GAAP financial statements.

* superseded by Chapter 1 of the *Conceptual Framework*.

Interim financial reports

BC96 IAS 34 *Interim Financial Reporting* states that the interim financial report is 'intended to provide an update on the latest complete set of annual financial statements' (paragraph 6). Thus, IAS 34 requires less disclosure in interim financial statements than IFRSs require in annual financial statements. However, an entity's interim financial report in accordance with IAS 34 is less helpful to users if the entity's latest annual financial statements were prepared using previous GAAP than if they were prepared in accordance with IFRSs. Therefore, the Board concluded that a first-time adopter's first interim financial report in accordance with IAS 34 should include sufficient information to enable users to understand how the transition to IFRSs affected previously reported annual, as well as interim, figures (paragraphs 32 and 33 of the IFRS).

Accounting policy changes in the year of adoption

BC97 In *Improvements to IFRSs* issued in May 2010, the Board clarified unclear wording concerning how changes in accounting policies should be addressed by a first-time adopter when those changes occur after the publication of the entity's first interim financial report. The Board decided that a first-time adopter is exempt from all the requirements of IAS 8 for the interim financial report it presents in accordance with IAS 34 for part of the period covered by its first IFRS financial statements and for its first IFRS financial statements. The Board concluded that to comply with IFRS 1's requirement to explain its transition to IFRSs, an entity should be required to explain any changes in its accounting policies or the IFRS 1 exemptions it applied between its first IFRS interim financial report and its first IFRS financial statements. The Board decided that the most useful information it could require was updated reconciliations between previous GAAP and IFRSs.

HKFRS 1 IG (Revised)
Revised ~~March 2012~~July 2014

Effective for annual periods
beginning on or after 1 July 2009

Guidance on Implementing
Hong Kong Financial Reporting Standards 1(Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

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

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from paragraph

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IG12 IAS 16 requires each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item to be depreciated separately. However, IAS 16 does not prescribe the unit of measure for recognition of an asset, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances (see IAS 16 paragraphs 9 and 43).

IG13 In some cases, the construction or commissioning of an asset results in an obligation for an entity to dismantle or remove the asset and restore the site on which the asset stands. An entity applies IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in recognising and measuring any resulting provision. The entity applies IAS 16 in determining the resulting amount included in the cost of the asset, before depreciation and impairment losses. Items such as depreciation and, when applicable, impairment losses cause differences between the carrying amount of the liability and the amount included in the carrying amount of the asset. An entity accounts for changes in such liabilities in accordance with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. However, paragraph D21 of IFRS 1 provides an exemption for changes that occurred before the date of transition to IFRSs, and prescribes an alternative treatment where the exemption is used. An example of the first-time adoption of IFRIC 1, which illustrates the use of this exemption, is given at paragraphs IG201–IG203.

IAS 17 *Leases*

IG14 At the date of transition to IFRSs, a lessee or lessor classifies leases as operating leases or finance leases on the basis of circumstances existing at the inception of the lease (IAS 17, paragraph 13). In some cases, the lessee and the lessor may agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification in accordance with IAS 17 had the changed terms been in effect at the inception of the lease. If so, the revised agreement is considered as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee) do not give rise to a new classification of a lease.

IG15 When IAS 17 was revised in 1997, the net cash investment method for recognising finance income of lessors was eliminated. IAS 17 permits finance lessors to eliminate this method prospectively. However, the transitional provisions in IAS 17 do not apply to an entity's opening IFRS statement of financial position (paragraph 9 of the IFRS). Therefore, a finance lessor measures finance lease receivables in its opening IFRS statement of financial position as if the net cash investment method had never been permitted.

IG16 SIC-15 *Operating Leases—Incentives* applies to lease terms beginning on or after 1 January 1999. However, a first-time adopter applies SIC-15 to all leases, whether they started before or after that date.

IAS 18 *Revenue*

IG17 If an entity has received amounts that do not yet qualify for recognition as revenue in accordance with IAS 18 (for example, the proceeds of a sale that does not qualify for revenue recognition), the entity recognises the amounts received as a liability in its opening IFRS statement of financial position and measures that liability at the amount received.

IAS 19 *Employee Benefits*

IG18 [Deleted]~~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 in accordance with IAS 19 will involve leaving some later actuarial gains and losses unrecognised (paragraph D10 of the IFRS). The transitional provisions in IAS 19 do not apply to an entity's opening IFRS statement of financial position (paragraph 9 of the IFRS).~~

IAS 23 *Borrowing Costs*

IG23 On first adopting IFRSs, an entity begins capitalising borrowing costs (IAS 23 as revised in 2007). In accordance with paragraph D23 of the IFRS, an entity:

(a) capitalises borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009 or the date of transition to IFRSs (whichever is later);

(b) may elect to designate any date before 1 January 2009 or the date of transition to IFRSs (whichever is later) and to capitalise borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

However, if the entity established a deemed cost for an asset, the entity does not capitalise borrowing costs incurred before the date of the measurement that established the deemed cost.

IG24 IAS 23 requires disclosure of interest capitalised during the period. Neither IAS 23 nor the IFRS requires disclosure of the cumulative amount capitalised.

IG25 [Deleted]

~~IAS 27~~ IFRS 10 *Consolidated ~~and Separate~~ Financial Statements*

IG26 A first-time adopter consolidates all subsidiaries (as defined in ~~IAS 27~~IFRS 10), unless ~~IAS 27~~ IFRS 10 requires otherwise.

IG27 If a first-time adopter did not consolidate a subsidiary in accordance with previous GAAP, then:

(a) in its consolidated financial statements, the first-time adopter measures the subsidiary's assets and liabilities at the same carrying amounts as in the IFRS financial statements of the subsidiary, after adjusting for consolidation procedures and for the effects of the business combination in which it acquired the subsidiary (paragraph D17 of the IFRS). If the subsidiary has not adopted IFRSs in its financial statements, the carrying amounts described in the previous sentence are those that IFRSs would require in those financial statements (paragraph C4(j) of the IFRS).

(b) if the parent acquired the subsidiary in a business combination before the date of transition to IFRS, the parent recognises goodwill, as explained in IG Example 6.

(c) if the parent did not acquire the subsidiary in a business combination because it created the subsidiary, the parent does not recognise goodwill.

IG28 When a first-time adopter adjusts the carrying amounts of assets and liabilities of its subsidiaries in preparing its opening IFRS statement of financial position, this may affect non-controlling interests and deferred tax.

IG29 IG Examples 8 and 9 illustrate paragraphs D16 and D17 of the IFRS, which address cases where a parent and its subsidiary become first-time adopters at different dates.

…continued

IG Example 11 Reconciliation of equity and total comprehensive income

4 A restructuring provision of CU250 was recognised in accordance with previous GAAP at 1 January 20X4, but did not qualify for recognition in accordance with IFRSs until the year ended 31 December 20X4. This increases administrative expenses for 20X4 in accordance with IFRSs.

5 Adjustments 1–4 above lead to a reduction of CU128 in deferred tax expense.

6 Available-for-sale financial assets carried at fair value in accordance with IFRSs increased in value by CU180 during 20X4. They were carried at cost in accordance with previous GAAP. The entity sold available-for-sale financial assets during the year, recognising a gain of CU40 in profit or loss. Of that realised gain CU30 had been included in the revaluation surplus as at 1 January 20X4 and is reclassified from revaluation surplus to profit or loss (as a reclassification adjustment).

7 The fair value of forward foreign exchange contracts that are effective hedges of forecast transactions decreased by CU40 during 20X4.

8 Adjustments 6 and 7 above lead to an increase of CU29 in deferred tax expense.

Explanation of material adjustments to the statement of cash flows for 20X4:

Income taxes of CU133 paid during 20X4 are classified as operating cash flows in accordance with IFRSs, but were included in a separate category of tax cash flows in accordance with previous GAAP. There are no other material differences between the statement of cash flows presented in accordance with IFRSs and the statement of cash flows presented in accordance with previous GAAP.

IFRS 2 *Share-based Payment*

IG64 A first-time adopter is encouraged, but not required, to apply IFRS 2 *Share-based Payment* to equity instruments that were granted after 7 November 2002 that vested before the later of (a) the date of transition to IFRSs and (b) 1 January 2005.

IG65 For example, if an entity's date of transition to IFRSs is 1 January 2004, the entity applies IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested at 1 January 2005. Conversely, if an entity's date of transition to IFRSs is 1 January 2010, the entity applies IFRS 2 to shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested at 1 January 2010.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

IG66 Paragraph B10 of the IFRS requires a first-time adopter to use its previous GAAP carrying amount of government loans existing at the date of transition to IFRS as the IFRS carrying amount of such loans at that date. A first-time adopter applies IAS 32 *Financial Instruments: Presentation* to classify such a loan as a financial liability or an equity instrument. Subsequently, the first-time adopter applies IFRS 9 to such a loan. To do so, the entity calculates the effective interest rate by comparing the carrying amount of the loan at the date of transition to IFRSs with the amount and timing of expected repayments to the government. IG Example 12 illustrates accounting for such a loan.

[Paragraphs IG6~~6~~7–IG200 reserved for possible guidance on future standards]

IG Example 12 Government loan at a below-market rate of interest at the date of transition to IFRSs

To encourage entities to expand their operations in a specified development zone where it is difficult for entities to obtain financing for their projects, the government provides loans at a below-market rate of interest to fund the purchase of manufacturing equipment.

Entity S's date of transition to IFRSs is 1 January 20X2.

In accordance with the development scheme, in 20X0 Entity S receives a loan at a below-market rate of interest from the government for CU100,000. Under previous GAAP, Entity S accounted for the loan as equity and the carrying amount under previous GAAP was CU100,000 at the date of transition to IFRSs. The amount repayable will be CU103,030 at 1 January 20X5.

No other payment is required under the terms of the loan and there are no future performance conditions attached to the loan. The information needed to measure the fair value of the loan was not obtained at the time of initially accounting for the loan.

The loan meets the definition of a financial liability in accordance with IAS 32. Entity S therefore reclassifies the government loan as a liability. It also uses the previous GAAP carrying amount of the loan at the date of transition to IFRSs as the carrying amount of the loan in the opening IFRS statement of financial position. Entity S therefore reclassifies the amount of CU100,000 from equity to liability in the opening IFRS statement of financial position. In order to measure the loan after the date of transition to IFRSs, the effective interest rate starting 1 January 20X2 is calculated as below:

$$= 3\sqrt{\left(\frac{103{,}030}{100{,}000}\right)} - 1$$

= 0.01

The carrying amounts of the loan are as follows:

Date	Carrying amount	Interest expense	Interest payable
	CU	CU	CU
1 January 20X2	100,000		
31 December 20X2	101,000	1,000	1,000
31 December 20X3	102,010	1,010	2,010
31 December 20X4	103,030	1,020	3,030

IFRIC Interpretations

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

IG201 IAS 16 requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located. IAS 37 requires the liability, both initially and subsequently, to be measured at the amount required to settle the present obligation at the end of the reporting period, reflecting a current market-based discount rate.

HKFRS 3 (Revised)
Revised ~~February 2012~~July 2014

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

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

CONTENTS

Introduction

Reasons for revising HKFRS 3

IN1 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) revising HKFRS 3 is to maintain international convergence arising from the revision of IFRS 3 *Business Combinations* (IFRS 3) by the International Accounting Standards Board (IASB). The HKICPA supported the reasons for revising IFRS 3 of the IASB.

The revised IFRS 3 is part of a joint effort by the IASB and the US Financial Accounting Standards Board (FASB) to improve financial reporting while promoting the international convergence of accounting standards. The IASB and FASB decided to address the accounting for business combinations in two phases. The IASB and the FASB deliberated the first phase separately. The FASB concluded its first phase in June 2001 by issuing FASB Statement No. 141 *Business Combinations*. The IASB concluded its first phase in March 2004 by issuing the previous version of IFRS 3 *Business Combinations*. The IASB's and FASB's primary conclusion in the first phase was that virtually all business combinations are acquisitions. Accordingly, the IASB and FASB decided to require the use of one method of accounting for business combinations—the acquisition method.

IN2 The second phase of the project addressed the guidance for applying the acquisition method. The IASB and FASB decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business combinations. Thus, they decided to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions. The IASB and FASB concluded the second phase of the project by issuing IFRS 3 and FASB Statement No. 141 (revised 2007) *Business Combinations* and the related amendments to IAS 27 *Consolidated and Separate Financial Statements* and FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*.*

IN3 The revised HKFRS 3 replaces HKFRS 3 (as issued in 2004) and comes into effect for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. Earlier application is permitted, provided that HKAS 27 (as amended in 2008) is applied at the same time.

Main features of the HKFRS

IN4 The objective of the HKFRS is to enhance the relevance, reliability and comparability of the information that an entity provides in its financial statements about a business combination and its effects. It does that by establishing principles and requirements for how an acquirer:

(a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;

(b) recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and

(c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

Core principle

IN5 An acquirer of a business recognises the assets acquired and liabilities assumed at their acquisition-date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition.

* The requirements for consolidated financial statements in IAS 27 were superseded by IFRS10 *Consolidated Financial Statements*, issued in May 2011. Topic 810 *Consolidation* in the *FASB Accounting Standards Codification*® codified the guidance in SFAS 160.

and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer

6 **For each business combination, one of the combining entities shall be identified as the acquirer.**

7 The guidance in ~~HKAS 27~~ HKFRS 10 *Consolidated ~~and Separate~~ Financial Statements* shall be used to identify the acquirer—the entity that obtains *control* of another entity, i.e. the acquiree. If a business combination has occurred but applying the guidance in ~~HKAS 27~~HKFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 shall be considered in making that determination.

Determining the acquisition date

8 **The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.**

9 The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition principle

10 **As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.**

Recognition conditions

11 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements*[*] at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post-combination financial statements in accordance with other HKFRSs.

12 In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former *owners*) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 51–53 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable HKFRSs.

* *Framework for the Preparation and Presentation of Financial Statements* was replaced by the *Conceptual Framework for Financial Reporting* in October 2010.

(b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by HKFRSs.

20 ~~Paragraphs B41-B45 provide guidance on measuring the fair value of particular identifiable assets and a non-controlling interest in an acquiree.~~ Paragraphs 24–31 specify the types of identifiable assets and liabilities that include items for which this HKFRS provides limited exceptions to the measurement principle.

Exceptions to the recognition or measurement principles

21 This HKFRS provides limited exceptions to its recognition and measurement principles. Paragraphs 22-31 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 22-31, which will result in some items being:

(a) recognised either by applying recognition conditions in addition to those in paragraphs 11 and 12 or by applying the requirements of other HKFRSs, with results that differ from applying the recognition principle and conditions.

(b) measured at an amount other than their acquisition-date fair values.

Exception to the recognition principle

Contingent liabilities

22 HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a contingent liability as:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

23 The requirements in HKAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to HKAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Paragraph 56 provides guidance on the subsequent accounting for contingent liabilities.

Exceptions to both the recognition and measurement principles

Income taxes

24 The acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with HKAS 12 *Income Taxes*.

25 The acquirer shall account for the potential tax effects of temporary differences and carryforwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with HKAS 12.

Employee benefits

26 The acquirer shall recognise and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with HKAS 19 *Employee Benefits*.

Indemnification assets

27 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognised at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognise the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary (paragraph B41 provides related application guidance).

28 In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingent liability that is not recognised at the acquisition date because its fair value is not reliably measurable at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an employee benefit, that is measured on a basis other than acquisition-date fair value. In those circumstances, the indemnification asset shall be recognised and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount. Paragraph 57 provides guidance on the subsequent accounting for an indemnification asset.

Exceptions to the measurement principle

Reacquired rights

29 The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals ~~in determining~~ when measuring its fair value. Paragraphs B35 and B36 provide related application guidance.

Share-based payment transactions

30 The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in HKFRS 2 *Share-based Payment* at the acquisition date. (This HKFRS refers to the result of that method as the 'market-based measure' of the share-based payment transaction.)

Assets held for sale

31 The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* at fair value less costs to sell in accordance with paragraphs 15-18 of that HKFRS.

Recognising and measuring goodwill or a gain from a bargain purchase

32 **The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:**

(a) the aggregate of:

(i) the consideration transferred measured in accordance with this HKFRS, which generally requires acquisition-date fair value (see paragraph 37);

(ii) the amount of any non-controlling interest in the acquiree measured in accordance with this HKFRS; and

(iii) in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held *equity interest* in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this HKFRS.

33 In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree ~~determined using a valuation technique~~ in place of the acquisition-date fair value of the consideration transferred (paragraph 32(a)(i)). Paragraphs B46-B49 provide related application guidance.

Bargain purchases

34 Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 32(b) exceeds the aggregate of the amounts specified in paragraph 32(a). If that excess remains after applying the requirements in paragraph 36, the acquirer shall recognise the resulting gain in profit or loss on the acquisition date. The gain shall be attributed to the acquirer.

35 A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 22-31 may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

36 Before recognising a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts this HKFRS requires to be recognised at the acquisition date for all of the following:

(a) the identifiable assets acquired and liabilities assumed;

(b) the non-controlling interest in the acquiree, if any;

(c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and

(d) the consideration transferred.

(b) the consideration transferred for the acquiree (or the other amount used in measuring goodwill);

(c) in a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer; and

(d) the resulting goodwill or gain on a bargain purchase.

47 The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognised or whether that information results from events that occurred after the acquisition date. Pertinent factors include the date when additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts. Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value ~~determined~~ measured at that date is likely to indicate an error in the provisional amount.

48 The acquirer recognises an increase (decrease) in the provisional amount recognised for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period may sometimes result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, part or all of which are covered by the acquiree's liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognised for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognised for the claim receivable from the insurer.

49 During the measurement period, the acquirer shall recognise adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Thus, the acquirer shall revise comparative information for prior periods presented in financial statements as needed, including making any change in depreciation, amortisation or other income effects recognised in completing the initial accounting.

50 After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Determining what is part of the business combination transaction

51 The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, ie amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant HKFRSs.

60 To meet the objective in paragraph 59, the acquirer shall disclose the information specified in paragraphs B64-B66.

61 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

62 To meet the objective in paragraph 61, the acquirer shall disclose the information specified in paragraph B67.

63 If the specific disclosures required by this and other HKFRSs do not meet the objectives set out in paragraphs 59 and 61, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

Effective date and transition

Effective date

64 This HKFRS shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. Earlier application is permitted. However, this HKFRS shall be applied only at the beginning of an annual reporting period that begins on or after 30 June 2007. If an entity applies this HKFRS before 1 July 2009, it shall disclose that fact and apply HKAS 27 (as amended in 2008) at the same time.

64A [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

64B *Improvements to HKFRSs* issued in May 2010 amended paragraphs 19, 30 and B56 and added paragraphs B62A and B62B. An entity shall apply those amendments for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective from the date when the entity first applied this HKFRS.

64C Paragraphs 65A–65E were added by *Improvements to HKFRSs* issued in May 2010. An entity shall apply those amendments for annual periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. The amendments shall be applied to contingent consideration balances arising from business combinations with an acquisition date prior to the application of this HKFRS, as issued in 2008.

64D [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

64E HKFRS 10, issued in June 2011, amended paragraphs 7, B13, B63(e) and Appendix A. An entity shall apply those amendments when it applies HKFRS 10.

64F HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended paragraphs 20, 29, 33, 47, amended the definition of fair value in Appendix A and amended paragraphs B22, B40, B43–B46, B49 and B64. An entity shall apply those amendments when it applies HKFRS 13.

Transition

65 Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this HKFRS shall not be adjusted upon application of this HKFRS.

65A Contingent consideration balances arising from business combinations whose acquisition dates preceded the date when an entity first applied this HKFRS as issued in 2008 shall not be adjusted upon first application of this HKFRS. Paragraphs 65B–65E shall be applied in the subsequent accounting for those balances. Paragraphs 65B–65E shall not apply to the accounting for contingent consideration balances arising from business combinations with acquisition dates on or after the date when the entity first applied this HKFRS as issued in 2008. In paragraphs 65B–65E business combination refers exclusively to business combinations whose acquisition date preceded the application of this HKFRS as issued in 2008.

65B If a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably.

65C A business combination agreement may allow for adjustments to the cost of the combination that are contingent on one or more future events. The adjustment might, for example, be contingent on a specified level of profit being maintained or achieved in future periods, or on the market price of the instruments issued being maintained. It is usually possible to estimate the amount of any such adjustment at the time of initially accounting for the combination without impairing the reliability of the information, even though some uncertainty exists. If the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.

65D However, when a business combination agreement provides for such an adjustment, that adjustment is not included in the cost of the combination at the time of initially accounting for the combination if it either is not probable or cannot be measured reliably. If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.

65E In some circumstances, the acquirer may be required to make a subsequent payment to the seller as compensation for a reduction in the value of the assets given, equity instruments issued or liabilities incurred or assumed by the acquirer in exchange for control of the acquiree. This is the case, for example, when the acquirer guarantees the market price of equity or debt instruments issued as part of the cost of the business combination and is required to issue additional equity or debt instruments to restore the originally determined cost. In such cases, no increase in the cost of the business combination is recognised. In the case of equity instruments, the fair value of the additional payment is offset by an equal reduction in the value attributed to the instruments initially issued. In the case of debt instruments, the additional payment is regarded as a reduction in the premium or an increase in the discount on the initial issue.

66 An entity, such as a mutual entity, that has not yet applied HKFRS 3 and had one or more business combinations that were accounted for using the purchase method shall apply the transition provisions in paragraphs B68 and B69.

Income taxes

67 For business combinations in which the acquisition date was before this HKFRS is applied, the acquirer shall apply the requirements of paragraph 68 of HKAS 12, as amended by this HKFRS, prospectively. That is to say, the acquirer shall not adjust the accounting for prior business combinations for previously recognised changes in recognised deferred tax assets. However, from the date when this HKFRS is applied, the acquirer shall recognise, as an adjustment to profit or loss (or, if HKAS 12 requires, outside profit or loss), changes in recognised deferred tax assets.

Withdrawal of HKFRS 3 (issued 2004)

68 This HKFRS supersedes HKFRS 3 *Business Combinations* issued in 2004 as amended in 2005 and 2007.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

acquiree	The business or businesses that the **acquirer** obtains control of in a **business combination**.
acquirer	The entity that obtains control of the **acquiree**.
acquisition date	The date on which the **acquirer** obtains control of the **acquiree**.
business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.
business combination	A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this HKFRS.
contingent consideration	Usually, an obligation of the **acquirer** to transfer additional assets or **equity interests** to the former owners of an **acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
~~**control**~~	~~The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.~~
equity interests	For the purposes of this HKFRS, *equity interests* is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of **mutual entities**.
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.~~ *Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13.)
goodwill	An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.
identifiable	An asset is *identifiable* if it either: (a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

B11 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

B12 In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

Identifying the acquirer (application of paragraphs 6 and 7)

B13 The guidance in ~~HKAS 27~~HKFRS 10 *Consolidated ~~and Separate~~ Financial Statements* shall be used to identify the acquirer – the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance in ~~HKAS 27~~ HKFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14-B18 shall be considered in making that determination.

B14 In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

B15 In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called ‘reverse acquisitions’, the issuing entity is the acquiree. Paragraphs B19-B27 provide guidance on accounting for reverse acquisitions. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) *the relative voting rights in the combined entity after the business combination* – The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) *the existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest* – The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

(c) *the composition of the governing body of the combined entity* – The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

(d) *the composition of the senior management of the combined entity* – The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

(e) *the terms of the exchange of equity interests* – The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

B22 Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect:

(a) the assets and liabilities of the legal subsidiary (the accounting acquirer) recognised and measured at their pre-combination carrying amounts.

(b) the assets and liabilities of the legal parent (the accounting acquiree) recognised and measured in accordance with this HKFRS.

(c) the retained earnings and other equity balances of the legal subsidiary (accounting acquirer) **before** the business combination.

(d) the amount recognised as issued equity interests in the consolidated financial statements determined by adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to the fair value of the legal parent (accounting acquiree)~~ determined in accordance with this HKFRS~~. However, the equity structure (ie the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.

(e) the non-controlling interest's proportionate share of the legal subsidiary's (accounting acquirer's) pre-combination carrying amounts of retained earnings and other equity interests as discussed in paragraphs B23 and B24.

Non-controlling interest

B23 In a reverse acquisition, some of the owners of the legal acquiree (the accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (the accounting acquiree). Those owners are treated as a non-controlling interest in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal acquiree that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal acquiree—not in the results and net assets of the combined entity. Conversely, even though the legal acquirer is the acquiree for accounting purposes, the owners of the legal acquirer have an interest in the results and net assets of the combined entity.

B24 The assets and liabilities of the legal acquiree are measured and recognised in the consolidated financial statements at their pre-combination carrying amounts (see paragraph B22(a)). Therefore, in a reverse acquisition the non-controlling interest reflects the non-controlling shareholders' proportionate interest in the pre-combination carrying amounts of the legal acquiree's net assets even if the non-controlling interests in other acquisitions are measured at their fair value at the acquisition date.

Earnings per share

B25 As noted in paragraph B22(d), the equity structure in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal acquirer (the accounting acquiree), including the equity interests issued by the legal acquirer to effect the business combination.

Reacquired rights

B35 As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill. Paragraph 29 provides guidance on measuring a reacquired right and paragraph 55 provides guidance on the subsequent accounting for a reacquired right.

B36 If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss. Paragraph B52 provides guidance for measuring that settlement gain or loss.

Assembled workforce and other items that are not identifiable

B37 The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

B38 The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not themselves assets at the acquisition date, the acquirer does not recognise them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

B39 After initial recognition, an acquirer accounts for intangible assets acquired in a business combination in accordance with the provisions of HKAS 38 *Intangible Assets*. However, as described in paragraph 3 of HKAS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other HKFRSs.

B40 The identifiability criteria determine whether an intangible asset is recognised separately from goodwill. However, the criteria neither provide guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in ~~estimating~~ measuring the fair value of an intangible asset. For example, the acquirer would take into account the assumptions that market participants would ~~consider~~use when pricing the intangible asset, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria. (However, see paragraph 29, which establishes an exception to the fair value measurement principle for reacquired rights recognised in a business combination.) Paragraphs 36 and 37 of HKAS 38 provide guidance for determining whether intangible assets should be combined into a single unit of account with other intangible or tangible assets.

Measuring the fair value of particular identifiable assets and a non-controlling interest in an acquiree (application of paragraphs 18 and 19)

Assets with uncertain cash flows (valuation allowances)

B41 The acquirer shall not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this HKFRS requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values, the acquirer does not recognise a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

Assets subject to operating leases in which the acquiree is the lessor

B42 In measuring the acquisition-date fair value of an asset such as a building or a patent that is subject to an operating lease in which the acquiree is the lessor, the acquirer shall take into account the terms of the lease. In other words, the acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms as paragraph B29 requires for leases in which the acquiree is the lessee.

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

B43 ~~For~~ To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired non-financial asset actively, ~~for example, a research and development intangible asset,~~ or it may not intend to use the asset ~~in a way that is different from the way in which other market participants would use it~~ according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the non-financial asset ~~at fair value determined in accordance with~~ assuming its highest and best use by ~~other~~ market participants in accordance with the appropriate valuation premise, both initially and when measuring fair value less costs of disposal for subsequent impairment testing.

Non-controlling interest in an acquiree

B44 This HKFRS allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a non-controlling interest on the basis of a quoted price in an active market ~~prices~~ for the equity shares (ie those not held by the acquirer). In other situations, however, a quoted price in an active market ~~price~~ for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.

B45 The fair values of the acquirer’s interest in the acquiree and the non-controlling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer’s interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a ~~minority~~non-controlling interest discount) in the per-share fair value of the non-controlling interest if market participants would take into account such a premium or discount when pricing the non-controlling interest.

Measuring goodwill or a gain from a bargain purchase

Measuring the acquisition-date fair value of the acquirer’s interest in the acquiree using valuation techniques (application of paragraph 33)

B46 In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see paragraphs 32–34). ~~The acquirer should measure the acquisition-date fair value of its interest in the acquiree using one or more valuation~~

~~techniques that are appropriate in the circumstances and for which sufficient data are available. If more than one valuation technique is used, the acquirer should evaluate the results of the techniques, considering the relevance and reliability of the inputs used and the extent of the available data.~~

Special considerations in applying the acquisition method to combinations of mutual entities (application of paragraph 33)

B47 When two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, paragraph 33 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred as consideration. In addition, the acquirer in a combination of mutual entities shall recognise the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.

B48 Although they are similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

B49 A fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, ~~an estimated cash flow model~~ a present value technique may be used to ~~determine~~measure the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

Determining what is part of the business combination transaction (application of paragraphs 51 and 52)

B50 The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction is part of the exchange for the acquiree or whether the transaction is separate from the business combination:

(a) **the reasons for the transaction** – Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers – and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

(b) **who initiated the transaction** – Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners

(a) HKAS 38 prescribes the accounting for identifiable intangible assets acquired in a business combination. The acquirer measures goodwill at the amount recognised at the acquisition date less any accumulated impairment losses. HKAS 36 *Impairment of Assets* prescribes the accounting for impairment losses.

(b) HKFRS 4 *Insurance Contracts* provides guidance on the subsequent accounting for an insurance contract acquired in a business combination.

(c) HKAS 12 prescribes the subsequent accounting for deferred tax assets (including unrecognised deferred tax assets) and liabilities acquired in a business combination.

(d) HKFRS 2 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that is attributable to employees' future services.

(e) ~~HKAS 27 (as amended in 2008)~~ HKFRS 10 provides guidance on accounting for changes in a parent's ownership interest in a subsidiary after control is obtained.

Disclosures (application of paragraphs 59 and 61)

B64 To meet the objective in paragraph 59, the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

(a) the name and a description of the acquiree.

(b) the acquisition date.

(c) the percentage of voting equity interests acquired.

(d) the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.

(e) a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

(f) the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

(i) cash;

(ii) other tangible or intangible assets, including a business or subsidiary of the acquirer;

(iii) liabilities incurred, for example, a liability for contingent consideration; and

(iv) equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of ~~determining~~ measuring the fair value of those instruments or interests.

(g) for contingent consideration arrangements and indemnification assets:

(i) the amount recognised as of the acquisition date;

(ii) a description of the arrangement and the basis for determining the amount of the payment; and

(o) for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:

(i) the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and

(ii) for each non-controlling interest in an acquiree measured at fair value, the valuation technique(s) and ~~key model~~ significant inputs used ~~for determining~~ to measure that value.

(p) in a business combination achieved in stages:

(i) the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

(ii) the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see paragraph 42) and the line item in the statement of comprehensive income in which that gain or loss is recognised.

(q) the following information:

(i) the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and

(ii) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This HKFRS uses the term ‘impracticable’ with the same meaning as in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

B65 For individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer shall disclose in aggregate the information required by paragraph B64(e)–(q).

B66 If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are authorised for issue, the acquirer shall disclose the information required by paragraph B64 unless the initial accounting for the business combination is incomplete at the time the financial statements are authorised for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

B67 To meet the objective in paragraph 61, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

(a) if the initial accounting for a business combination is incomplete (see paragraph 45) for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally:

(i) the reasons why the initial accounting for the business combination is incomplete;

(ii) the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and

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

Basis for Conclusions
HKFRS 3 *Business Combinations*

HKFRS 3 is based on IFRS 3 *Business Combinations*. In approving HKFRS 3, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 3. Accordingly, there are no significant differences between HKFRS 3 and IFRS 3. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 3 referred to below generally correspond with those in HKFRS 3.

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cannot be identified or as one in which the acquirer is substantially modified by the transaction. However, the boards observed that those transactions have been accounted for by the acquisition method and they decided not to change that practice.

BC57 Neither the IASB nor the FASB has on its agenda a project to consider the fresh start method. However, both boards have expressed interest in considering whether joint venture formations and some formations of new entities in multi-party business combinations should be accounted for by the fresh start method. Depending on the relative priorities of that topic and other topics competing for their agendas when time becomes available, the boards might undertake a joint project to consider those issues at some future date.

Scope

BC58 The revised standards exclude from their scope some transactions that were also excluded from the scope of both IFRS 3 and SFAS 141. However, the revised standards include within their scope combinations involving only mutual entities and combinations achieved by contract alone, which were excluded from the scope of IFRS 3 and SFAS 141. Paragraphs BC59–BC79 discuss the boards' reasons for those conclusions.

Joint ventures and combinations of entities under common control

BC59 Formations of joint ventures and combinations of entities under common control are excluded from the scope of the revised standards. Those transactions were also excluded from the scope of both IFRS 3 and SFAS 141, and the boards continue to believe that issues related to such combinations are appropriately excluded from the scope of this project. The boards are aware of nothing that has happened since IFRS 3 and SFAS 141 were issued to suggest that the revised standards should be delayed to address the accounting for those events.

BC60 In developing IFRS 3, the IASB considered whether it should amend the definition of joint control in IAS 31 *Interests in Joint Ventures*[*] because it was concerned that its decision to eliminate the pooling method would create incentives for business combinations to be structured to meet the definition of a joint venture. After considering comments on the definition proposed in ED 3, the IASB revised the definition of joint control in IAS 31 to clarify that:

(a) unanimous consent on **all** financial and operating decisions is not necessary for an arrangement to satisfy the definition of a joint venture-unanimous consent on only strategic decisions is sufficient.

(b) in the absence of a contractual agreement requiring unanimous consent to strategic financial and operating decisions, a transaction in which the owners of multiple businesses agree to combine their businesses into a new entity (sometimes referred to as a roll-up transaction) should be accounted for by the acquisition method. Majority consent on such decisions is not sufficient.

BC61 In developing SFAS 141, the FASB noted that constituents consider the guidance in paragraph 3(d) of APB Opinion No. 18 *The Equity Method of Accounting for Investments in Common Stock* in assessing whether an entity is a joint venture, and it decided not to change that practice in its project on business combinations.

Not-for-profit organisations

BC62 The FASB also decided to exclude from the scope of SFAS 141(R) business combinations of not-for-profit organisations and acquisitions of for-profit businesses by not-for-profit organisations. Some aspects of combinations of not-for-profit organisations are different from combinations of business entities. For example, it cannot be presumed that combinations of organisations that serve a public interest are necessarily exchange transactions in which willing parties exchange equal values. For that reason, the FASB is

[*] IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

BC90 In developing SFAS 141, the FASB observed that identifying the acquirer might be difficult in some multi-party business combinations, particularly those that might not be acquisitions but are required to be accounted for as such. The FASB noted that in those circumstances it might be helpful to consider additional factors such as which of the entities initiated the combination and whether the reported amounts of assets, revenues and earnings of one of the combining entities significantly exceed those of the others. Respondents to the 1999 Exposure Draft generally agreed, and SFAS 141 included that guidance.

BC91 In addition, as suggested by respondents, the FASB decided that SFAS 141 should explicitly state that in some business combinations, such as reverse acquisitions, the entity that issues the equity interests may not be the acquirer. In a reverse acquisition, one entity (Entity A) obtains ownership of the equity instruments of another entity (Entity B), but Entity A issues enough of its own voting equity instruments as consideration in the exchange transaction for control of the combined entity to pass to the owners of Entity B.

BC92 If a new entity is formed to issue equity instruments to effect a business combination, SFAS 141 required that one of the combining entities that existed before the combination must be identified as the acquirer for essentially the same reasons as those discussed in paragraphs BC98–BC101 in the context of IFRS 3's similar requirement.

Developing the guidance in IFRS 3

BC93 As proposed in ED 3, IFRS 3 carried forward from IAS 22 the principle that in a business combination accounted for using the acquisition method the acquirer is the combining entity that obtains control of the other combining entities or businesses. The IASB observed that using the control concept as the basis for identifying the acquirer is consistent with using the control concept in IAS 27 *Consolidated and Separate Financial Statements* to define the boundaries of the reporting entity and to provide the basis for establishing the existence of a parent-subsidiary relationship.* IFRS 3 also carried forward the guidance in IAS 22 that control is the power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities. IFRS 3 also provided the same guidance as IAS 22 for identifying the acquirer if one of the combining entities might have obtained control even if it does not acquire more than one-half of the voting rights of another combining entity.

Identifying an acquirer in a business combination effected through an exchange of equity interests

BC94 In developing ED 3 and IFRS 3, the IASB decided not to carry forward the guidance in IAS 22 on identifying which of the combining entities is the acquirer in a reverse acquisition. IAS 22 required the entity whose owners control the combined entity to be treated as the acquirer. That approach presumed that in a business combination effected through an exchange of equity interests, the entity whose owners control the combined entity is always the entity with the power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities. The IASB observed that because the presumption is not always accurate, carrying it forward would in effect override the control concept for identifying the acquirer.

BC95 The IASB observed that the control concept focuses on the relationship between two entities, in particular, whether one entity has the power to govern the financial and operating policies of another so as to obtain benefits from its activities. Therefore, determining which of the combining entities has, as a consequence of the combination, the power to govern the financial and operating policies of the other so as to obtain benefits from its activities is fundamental to identifying the acquirer, regardless of the form of the consideration.

BC96 The IASB also observed that in some reverse acquisitions, the acquirer may be the entity whose equity interests have been acquired and the acquiree is the issuing entity. For example, a private entity might arrange to have itself 'acquired' by a smaller public entity

* The consolidation requirements in IAS 27 were superseded, and the definition of control was revised, by IFRS 10 *Consolidated Financial Statements* issued in May 2011.

development assets acquired in a business combination to be recognised regardless of whether they have an alternative future use.

BC151 Relatively few respondents to the 2005 Exposure Draft commented on the proposed accounting for research and development assets. Those who did so generally disagreed with those proposals (they also generally applied US GAAP rather than IFRSs), citing either or both of the following concerns as support for their view:

(a) In-process research and development may not meet the definition of an asset in the FASB's Concepts Statement 6 because its low likelihood of success does not represent **probable** future economic benefits.

(b) The fair value of in-process research and development may not be measurable with sufficient reliability for recognition in financial statements.

The boards rejected both of those views for the reasons explained in the following paragraphs.

BC152 The boards agreed with respondents that the likelihood that an individual research and development project will result in a profitable product is often low. However, the boards also noted that the use of the word *probable* in the FASB's Concepts Statement 6 refers only to something that is not certain. The definition does not use that term as a recognition criterion that specifies the degree of probability of the inflow or outflow of future economic benefits that must be present for an item to qualify for recognition. Therefore, the boards concluded that in-process research and development acquired in a business combination will generally satisfy the definition of an asset because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from that research and development. Uncertainty about the outcome of an individual project is reflected in measuring its fair value.

BC153 The boards also agreed that determining the fair value of in-process research and development requires the use of estimates and judgement, and the resulting amount will generally not be as reliable as the fair values of other assets for which quoted prices in active markets are available. However, the boards observed that use of estimates and judgement, by itself, does not mean that information is unreliable; reliability does not require precision or certainty. For example, paragraph 86 of the IASB's *Framework*[*] says that 'In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.' The boards also noted that the requirement to measure the fair value of in-process research and development assets acquired in a business combination is not new–not even in US GAAP. In accordance with FASB Interpretation 4, that amount was measured but immediately written off. Moreover, respondents to the 2005 Exposure Draft that apply IFRSs generally did not mention any problems with complying with the provisions of IFRS 3 on research and development assets, which are the same as those in the revised standards.

BC154 In developing the 2005 Exposure Draft, the FASB also considered whether it could make further improvements by extending the recognition provisions of SFAS 141(R) for research and development assets to purchases of in-process research and development assets outside a business combination. At that time, the FASB decided not to do so because the additional time needed to deliberate the related issues would have unduly delayed the revised standards.

BC155 Some respondents to the 2005 Exposure Draft objected to the resulting inconsistent US GAAP requirements for research and development assets acquired in a business combination and those acquired in another type of transaction. The FASB agreed with respondents that inconsistent accounting for research and development assets depending on how they are acquired is undesirable. Therefore, the FASB expects to reconsider the accounting for research and development assets acquired by means other than in a business combination separately from its project on business combinations.

[*] now paragraph 4.41 of the *Conceptual Framework*

BC195 The FASB decided to provide the guidance on recognition and measurement, including subsequent measurement, of insurance and reinsurance contracts acquired in a business combination by means of an amendment to SFAS 60. That parallels the location of the IASB's business combination guidance for insurance contracts in IFRS 4 and will make it easier to address any changes in that guidance that might result if the FASB and the IASB eventually undertake a joint project to reconsider comprehensively the accounting for insurance contracts.

BC196 Paragraphs 31–33 of IFRS 4 deal with limited aspects of insurance contracts acquired in a business combination. That guidance was developed in phase I of the IASB's project on insurance contracts. The IASB decided not to amend those paragraphs in phase II of the business combinations project, so as not to pre-empt phase II of the IASB's project on insurance contracts. In May 2007 the IASB published its initial thoughts for phase II of that project in a discussion paper *Preliminary Views on Insurance Contracts*.

Measurement

BC197 Paragraph 18 of the revised IFRS 3 establishes the principle that the identifiable assets acquired and liabilities assumed should be measured at their acquisition-date fair values. The reasons for that principle and its application to contingencies and non-controlling interests are discussed in paragraphs BC198–BC245, and the definition of fair value[*] is discussed in paragraphs BC246–BC251. The revised standards provide guidance on determining the acquisition-date fair value of particular types of assets acquired, which is discussed in paragraphs BC252–BC262. The exceptions to the measurement principle are discussed in paragraphs BC279–BC311.

Why establish fair value as the measurement principle?

Identifiable assets acquired and liabilities assumed

BC198 In developing the measurement principle in the revised standards, the boards concluded that fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination. Measurement at fair value also provides information that is more comparable and understandable than measurement at cost or on the basis of allocating the total cost of an acquisition. Both IFRS 3 and SFAS 141 required allocation of that cost on the basis of the fair value of the assets acquired and the liabilities assumed. However, other guidance in those standards required measurements that were other than fair value. Moreover, SFAS 141's requirements for measuring identifiable assets acquired and liabilities assumed in an acquisition achieved in stages (a step acquisition) and in acquisitions of less than all of the equity interests in the acquiree resulted in another difference between fair value measurement of identifiable assets and liabilities and the process of accumulating and allocating costs. Those requirements were the same as the benchmark treatment in IAS 22, which IFRS 3 replaced. The following paragraphs discuss both the IASB's reasons for that change to IAS 22 and the FASB's reasons for the change to SFAS 141's requirements for step acquisitions, as well as providing additional discussion of the reasons for the fair value measurement principle in the revised standards.

BC199 In developing IFRS 3 and SFAS 141(R), respectively, the boards examined the inconsistencies that resulted from applying the benchmark treatment in IAS 22 and the provisions of SFAS 141, and the related implementation guidance, to acquisitions of businesses. For a step acquisition, that process involved accumulating the costs or carrying amounts of earlier purchases of interests in an entity, which may have occurred years or decades ago. Those amounts were added to the current costs to purchase incremental interests in the acquiree on the acquisition date. The accumulated amounts of those purchases were then allocated to the assets acquired and liabilities assumed. Allocating the accumulated amounts generally resulted in recognising the identifiable assets and liabilities of the acquiree at a mixture of current exchange prices and carry-forward book values for each earlier purchase rather than at their acquisition-date fair values. Users of financial statements have long criticised those practices as resulting

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

be unlikely to increase appreciably the consistency with which different entities measured non-controlling interests.

BC216 The IASB reluctantly concluded that the only way the revised IFRS 3 would receive sufficient votes to be issued was if it permitted an acquirer to measure a non-controlling interest either at fair value or at its proportionate share of the acquiree's identifiable net assets, on a transaction-by-transaction basis.

Effects of the optional measurement of non-controlling interests

BC217 The IASB noted that there are likely to be three main differences in outcome that occur when the non-controlling interest is measured as its proportionate share of the acquiree's identifiable net assets, rather than at fair value. First, the amounts recognised in a business combination for non-controlling interests and goodwill are likely to be lower (and these should be the only two items affected on initial recognition). Second, if a cash-generating unit is subsequently impaired, any resulting impairment of goodwill recognised through income is likely to be lower than it would have been if the non-controlling interest had been measured at fair value (although it does not affect the impairment loss attributable to the controlling interest).

BC218 The third difference arises if the acquirer subsequently purchases some (or all) of the shares held by the non-controlling shareholders. If the non-controlling interests are acquired, presumably at fair value, the equity of the group is reduced by the non-controlling interests' share of any unrecognised changes in the fair value of the net assets of the business, including goodwill. If the non-controlling interest is measured initially as a proportionate share of the acquiree's identifiable net assets, rather than at fair value, that reduction in the reported equity attributable to the acquirer is likely to be larger. This matter was considered further in the IASB's deliberations on the proposed amendments to IAS 27.[*]

Convergence

BC219 Both boards decided that, although they would have preferred to have a common measurement attribute for non-controlling interests, they had considered and removed as many differences between IFRS 3 and SFAS 141 as was practicable.

BC220 The boards were unable to achieve convergence of their respective requirements in several areas because of existing differences between IFRSs and US GAAP requirements outside a business combination. The boards observed that the accounting for impairments in IFRSs is different from that in US GAAP. This means that even if the boards converged on the initial measurement of non-controlling interests, and therefore goodwill, the subsequent accounting for goodwill would not have converged. Although this is not a good reason for allowing divergence in the initial measurement of non-controlling interests, it was a mitigating factor.

BC221 Because most business combinations do not involve a non-controlling interest, the boards also observed that the revised standards will align most of the accounting for most business combinations regardless of the different accounting for non-controlling interests in the revised standards.

Subsequent improvements to IFRS 3

BC221A In *Improvements to IFRSs* issued in May 2010, the Board addressed a concern that permitting the measurement choice for certain components of non-controlling interest might result in inappropriate measurement of those components in some circumstances. The Board decided to limit the choice to non-controlling interests that are present ownership instruments and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. The amendment requires the acquirer to measure all other components of non-controlling interest at the acquisition-date fair value, unless IFRSs require another measurement basis. For example, if a share-based payment

[*] The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The requirements with respect to transactions between owners in their capacity as owners did not change.

BC240 The FASB understands that distinguishing between measurement period adjustments and other changes in the amounts of assets and liabilities arising from contingencies will sometimes be difficult. It observed, however, that similar difficulties exist for other assets acquired and liabilities assumed in a business combination; changes in the amounts of those assets and liabilities after the acquisition date are included in earnings. The FASB saw no compelling reason to treat items arising from contingencies differently.

BC241 Those who favoured reporting subsequent changes in the amounts recognised for assets and liabilities arising from contingencies in other comprehensive income rather than in earnings generally analogised to the present accounting for available-for-sale securities. They said that items arising from contingencies were not 'realised' until the contingency is resolved. The FASB rejected that alternative because it saw no compelling reason to add to the category of items that are initially recognised as other comprehensive income and later 'recycled' to earnings. The FASB considers reporting subsequent changes in the amounts of items arising from contingencies in earnings not only conceptually superior to reporting those changes only in comprehensive income but also consistent with the way in which other changes in amounts of items acquired or assumed in a business combination are recognised.

The IASB's conclusions on initial and subsequent measurement of contingent liabilities

BC242 As noted in paragraph BC223, the IASB's measurement guidance on contingencies carries forward the related guidance in IFRS 3 (except for clarifying that an acquirer cannot recognise a contingency that is not a liability), pending completion of the project to revise IAS 37. Accordingly, contingent liabilities recognised in a business combination are initially measured at their acquisition-date fair values.

BC243 In developing IFRS 3, the IASB observed that not specifying the subsequent accounting for contingent liabilities recognised in a business combination might result in inappropriately derecognising some or all of those contingent liabilities immediately after the combination.

BC244 In ED 3 the IASB proposed that a contingent liability recognised in a business combination should be excluded from the scope of IAS 37 and subsequently measured at fair value with changes in fair value recognised in profit or loss until the liability is settled or the uncertain future event described in the definition of a contingent liability is resolved. In considering respondents' comments on this issue, the IASB noted that subsequently measuring such contingent liabilities at fair value would be inconsistent with the conclusions it reached on the accounting for financial guarantees and commitments to provide loans at below-market interest rates when it revised IAS 39.

BC245 The IASB decided to revise the proposal in ED 3 for consistency with IAS 39. Therefore, the revised IFRS 3 requires contingent liabilities recognised in a business combination to be measured after their initial recognition at the higher of:

(a) the amount that would be recognised in accordance with IAS 37; and

(b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

Definition of fair value[*]

BC246 The revised IFRS 3 and SFAS 141(R) each use the same definition of fair value that the IASB and the FASB respectively use in their other standards. Specifically, IAS 39 and other IFRSs define fair value as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction' and the revised IFRS 3 uses that definition. SFAS 157, on the other hand, defines *fair value* as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' and that definition is used in SFAS 141(R).[#]

[*] IFRS 13, issued in May 2011, defines fair value.

[#] IFRS 13, issued in May 2011, is the result of the IASB's and the FASB's joint project on fair value measurement. As a result, the definition of fair value in IFRSs is identical to the definition in US GAAP (Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*® codified SFAS 157).

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

BC261 While the revised standards were being developed, the FASB received enquiries about inconsistencies in practice in accordance with SFAS 141 related to measuring particular intangible assets that an acquirer intends not to use or intends to use in a way different from the way other market participants would use them. For example, if the acquirer did not intend to use a brand name acquired in a business combination, some entities assigned no value to the asset and other entities measured it at the amount at which market participants could be expected to exchange the asset, ie at its fair value.

BC262 To avoid such inconsistencies in practice, the boards decided to clarify the measurement of assets that an acquirer intends not to use (paragraph B43 of the revised IFRS 3). The intention of both IFRS 3 and SFAS 141 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them. The FASB observed that measuring such assets in accordance with their highest and best use is consistent with SFAS 157. Paragraph A12 of SFAS 157 illustrates determining the fair value of an in-process research and development project acquired in a business combination that the acquirer does not intend to complete. The IASB understands from its consultation with preparers, valuation experts and auditors that IFRS 3 was applied in the way the revised standards require.*

Exceptions to the recognition or measurement principle

BC263 As indicated in paragraphs 14 and 20 of the revised IFRS 3, the revised standards include limited exceptions to the recognition and measurement principles. Paragraphs BC265–BC311 discuss the types of identifiable assets and liabilities for which exceptions are provided and the reasons for those exceptions.

BC264 It is important to note that not every item that falls into a particular type of asset or liability is an exception to either the recognition or the measurement principle (or both). For example, contingent liabilities are identified as an exception to the recognition principle because the revised IFRS 3 includes a recognition condition for them in addition to the recognition conditions in paragraphs 11 and 12. Although applying that additional condition will result in not recognising some contingent liabilities, those that meet the additional condition will be recognised in accordance with the recognition principle. Another example is employee benefits, which are identified as a type of asset or liability for which exceptions to both the recognition and the measurement principles are provided. As discussed further in paragraphs BC296–BC300, the acquirer is required to recognise and measure liabilities and any related assets resulting from the acquiree's employee benefit arrangements in accordance with IAS 19 *Employee Benefits* rather than by applying the recognition and measurement principles in the revised IFRS 3. Applying the requirements of IAS 19 will result in recognising many, if not most, types of employee benefit liabilities in the same way as would result from applying the recognition principle (see paragraph BC297). However, others, for example withdrawal liabilities from multi-employer plans for entities applying US GAAP, are not necessarily consistent with the recognition principle. In addition, applying the requirements of IAS 19 generally will result in measuring liabilities for employee benefits (and any related assets) on a basis other than their acquisition-date fair values. However, applying the requirements of SFAS 146 to one-off termination benefits results in measuring liabilities for those benefits at their acquisition-date fair values.

Exception to the recognition principle

Assets and liabilities arising from contingencies

BC265 Both the FASB's conclusions on recognising assets and liabilities arising from contingencies and the IASB's conclusions on recognising contingent liabilities resulted in exceptions to the recognition principle in the revised standards because both will result in some items being unrecognised at the acquisition date. However, the details of the

* IFRS 13, issued in May 2011, describes the concept of highest and best use and provides examples of its application in a business combination.

exception, the asset would be measured at fair value, and the liability would be measured in accordance with the pertinent income tax accounting requirements, such as FASB Interpretation 48 for an entity that applies US GAAP, because income taxes are an exception to the fair value measurement principle. Those two amounts would differ. The boards agreed with constituents that an asset representing an indemnification related to a specific liability should be recognised and measured on the same basis as that liability.

BC303 The boards also provided an exception to the recognition principle for indemnification assets. The reasons for that exception are much the same as the reasons why the boards exempted deferred tax assets and liabilities and employee benefits from that principle. Providing an exception to the recognition principle for indemnification assets clarifies that the acquirer does not apply that principle in determining whether or when to recognise such an asset. Rather, the acquirer recognises the asset when it recognises the related liability. Therefore, the revised standards provide an exception to the recognition and measurement principles for indemnification assets.

Exceptions to the measurement principle

BC304 In addition to the exceptions to both the recognition and measurement principles discussed above, the revised standards provide exceptions to the measurement principle for particular types of assets acquired or liabilities assumed in a business combination. Those exceptions are discussed in paragraphs BC305–BC311.

Temporary exception for assets held for sale

BC305 The 2005 Exposure Draft proposed that non-current assets qualifying as held for sale at the acquisition date under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* or FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144) should be measured as those standards require–at fair value less costs to sell. The purpose of that proposed exception was to avoid the need to recognise a loss for the selling costs immediately after a business combination (referred to as a *Day 2 loss* because in theory it would be recognised on the day after the acquisition date). That Day 2 loss would result if the assets were initially measured at fair value but the acquirer then applied either IFRS 5 or SFAS 144, requiring measurement at fair value less costs to sell, for subsequent accounting. Because that loss would stem entirely from different measurement requirements for assets held for sale acquired in a business combination and for assets already held that are classified as held for sale, the reported loss would not faithfully represent the activities of the acquirer.

BC306 After considering responses to the 2005 Exposure Draft, the boards decided that the exception to the measurement principle for assets held for sale should be eliminated. The definitions of fair value[*] in the revised standards, and their application in other areas focuses on market data. Costs that a buyer (acquirer) incurs to purchase or expects to incur to sell an asset are excluded from the amount at which an asset is measured. The boards concluded that disposal costs should also be excluded from the measurement of assets held for sale.

BC307 However, avoiding the Day 2 loss described in paragraph BC305 will require the boards to amend IFRS 5 and SFAS 144 to require assets classified as held for sale to be measured at fair value rather than at fair value less costs to sell. The boards decided to do that, but their respective due process procedures require those amendments to be made in separate projects to give constituents the opportunity to comment on the proposed changes. Although the boards intend the amendments of IFRS 5 and SFAS 144 to be effective at the same time as the revised standards, they decided as an interim step to include a measurement exception until completion of the amendments.

[*] IFRS 13, issued in May 2011, defines fair value and describes the effect that transaction costs have on a fair value measurement.

special considerations for measuring the fair value of mutual entities, some acquirers might neglect to consider relevant assumptions that market participants would make about future member benefits when using a valuation technique. For example, the acquirer of a co-operative entity should consider the value of the member discounts in its determination of the fair value of its interest in the acquiree. Therefore, the boards decided to include a discussion of special considerations in measuring the fair value of mutual entities (paragraphs B47–B49 of the revised IFRS 3).*

Measuring consideration and determining whether particular items are part of the consideration transferred for the acquiree

BC337 Paragraphs BC338–BC360 discuss the boards' conclusions on measuring specific items of consideration that are often transferred by acquirers. Paragraphs BC361–BC370 then discuss whether particular replacement awards of share-based remuneration and acquisition-related costs incurred by acquirers are part of the consideration transferred for the acquiree.

Measurement date for equity securities transferred

BC338 The guidance in IFRS 3 and SFAS 141 on the measurement date for equity securities transferred as consideration in a business combination differed, and SFAS 141's guidance on that issue was contradictory. Paragraph 22 of SFAS 141, which was carried forward from APB Opinion 16, said that the market price for a reasonable period before and after the date that the terms of the acquisition are agreed to and announced should be considered in determining the fair value of the securities issued. That effectively established the agreement date as the measurement date for equity securities issued as consideration. However, paragraph 49 of SFAS 141, which was also carried forward from APB Opinion 16, said that the cost of an acquiree should be determined as of the acquisition date. IFRS 3, on the other hand, required measuring the consideration transferred in a business combination at its fair value on the exchange date, which was the acquisition date for a combination in which control is achieved in a single transaction. (IFRS 3, like SFAS 141, included special guidance on determining the cost of a business combination in which control is achieved in stages.) In their deliberations leading to the 2005 Exposure Draft, the boards decided that the fair value of equity securities issued as consideration in a business combination should be measured at the acquisition date.

BC339 In reaching their conclusions on this issue, the boards considered the reasons for the consensus reached in EITF Issue No. 99-12 *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*. That consensus states that the value of the acquirer's marketable equity securities issued to effect a business combination should be determined on the basis of the market price of the securities over a reasonable period before and after the terms of the acquisition are agreed to and announced. The arguments for that consensus are based on the view that the announcement of a transaction, and the related agreements, normally bind the parties to the transaction so that the acquirer is obliged at that point to issue the equity securities at the closing date. If the parties are bound to the transaction at the agreement (announcement) date, the value of the underlying securities on that date best reflects the value of the bargained exchange. The boards did not find those arguments compelling. The boards observed that to make the announcement of a recommended transaction binding generally requires shareholders' authorisation or another binding event, which also gives rise to the change in control of the acquiree.

BC340 Additionally, the boards noted that measuring the fair value of equity securities issued on the agreement date (or on the basis of the market price of the securities for a short period before and after that date) did not result in a consistent measure of the consideration transferred. The fair values of all other forms of consideration transferred are measured at the acquisition date. The boards decided that all forms of consideration transferred should be valued on the same date, which should also be the same date as when the assets acquired and liabilities assumed are measured. The boards also observed that negotiations between an acquirer and an acquiree typically provide for share adjustments

* The combination of IFRS 3 and IFRS 13, issued in May 2011, provides guidance for measuring the fair value of an acquirer's interest in the acquiree (including mutual entities).

IFRS 3, to provide information that enables users of an entity's financial statements to evaluate changes in the carrying amount of goodwill during the period, is effectively included in the objective in paragraph 61. Thus, the boards combined those two objectives.

BC420 In addition, both boards concluded, as the IASB did in developing IFRS 3, that it is not necessary (or possible) to identify all of the specific information that may be necessary to meet those objectives for all business combinations. Rather, the revised standards specify particular disclosures that are generally required to meet those objectives and require acquirers to disclose any additional information about the circumstances surrounding a particular business combination that they consider necessary to meet those objectives (paragraph 63 of the revised IFRS 3).

BC421 Changes to the disclosure requirements of IFRS 3 and SFAS 141 include the elimination of disclosures of amounts or information that was based on applying the cost allocation (purchase price) method for assigning amounts to assets and liabilities that is replaced by the revised standards' fair value measurement principle. Some of those disclosures are modified to retain the information but conform the amounts to be disclosed with the fair value measurement principle.

BC422 The boards added some disclosure requirements to those in IFRS 3, SFAS 141 or both and modified or eliminated others. Those changes are described below, together with an indication of how the changes relate to each board's previous requirements and references to related discussions in other parts of this Basis for Conclusions where pertinent.[*]

(a) In response to requests from some commentators on the 2005 Exposure Draft, the boards added to both IFRS 3 and SFAS 141 disclosure of information about receivables acquired. (paragraphs BC258–BC260)

(b) The boards modified both IFRS 3's and SFAS 141's disclosures about contingent consideration in a business combination to make them consistent with the revised standards' requirements for contingent consideration. Paragraph B64(g) of the revised IFRS 3 describes the specific disclosures now required.

(c) The FASB added to SFAS 141 disclosure of the revenue and earnings of the acquiree, if practicable, for a minimum of the period from the acquisition date to the end of the current year. The disclosure is required only from public business entities for the current year, the current interim period and cumulative interim periods from the acquisition date to the end of the current year. IFRS 3 already required disclosure of the amount of the acquiree's profit or loss included in the acquirer's profit or loss for the period, unless that was impracticable; the IASB added revenues to that disclosure. (paragraphs BC423–BC428)

(d) The FASB modified SFAS 141's disclosure of supplemental pro forma information about results of operations for the comparable prior period presented to focus on revenue and earnings of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations during the current year had been the beginning of the comparable prior annual reporting period. The disclosure is required only from public entities and only if practicable. The IASB decided not to add that disclosure. (paragraph BC428)

(e) The FASB replaced SFAS 141's disclosure of the period for which the results of operations of the acquiree are included in the income statement of the combined entity with disclosure of the acquisition date–a disclosure that IFRS 3 already required. SFAS 141(R) no longer permits the alternative practice of reporting revenues and expenses of the acquiree as if the acquisition occurred as of the beginning of the year (or a designated date) with a reduction to eliminate the acquiree's pre-acquisition period earnings. (paragraphs BC108–BC110)

[*] IFRS 13, issued in May 2011, requires disclosures about fair value measurements after initial recognition. Although the disclosures required by IFRS 13 are not required for IFRS 3, the wording has been aligned.

BC428 If comparative financial statements are presented, the FASB decided to require disclosure of supplemental pro forma information about the revenue and earnings of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations during the current year had been the beginning of the comparable prior annual reporting period. The disclosure is required only for public entities and only if practicable. The IASB considered also requiring that disclosure, but it observed that the needed information would be particularly difficult and costly to obtain in the international environment. An entity that prepares its financial statements in accordance with IFRSs might in a given year acquire other entities that had previously applied the domestic reporting requirements of several different countries. Because the IASB did not consider it feasible to require the disclosure in the international environment, the revised IFRS 3 requires only disclosure of revenues and profit or loss for the current reporting period determined as though the acquisition date for all combinations during the period had been as of the beginning of the annual reporting period.

Effective date and transition

BC429 SFAS 141(R) is effective for 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, ie for 2009 financial statements. The IASB decided to provide a slightly later effective date. The revised IFRS 3 is effective for 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. The IASB made a commitment to its constituents that there would be a transition period of approximately 18 months between the publication date and the effective date of the revised IFRS 3 as part of its commitment to have a period of stability following the initial transition to IFRSs. The FASB decided to make SFAS 141(R) effective as soon as practicable, ie for 2009 financial statements. The FASB believes that that effective date provides sufficient time for entities and their auditors to analyse, interpret and prepare for implementation of the provisions of SFAS 141(R).

BC430 The boards also concluded that the effective date of the revised standards should be the same as that of the amendments to their respective consolidation standards (FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements* and the IASB's amendments to IAS 27). Particular provisions in those amendments, which address the subsequent accounting for an acquiree in consolidated financial statements, are related to provisions in the revised standards that address the initial accounting for an acquiree at the acquisition date.[*] The boards concluded that linking the timing of the changes in accounting required by those amendments to those required by the revised standards would minimise disruptions to practice, which benefits both preparers and users of financial statements.

BC431 SFAS 141(R) prohibits early application and the revised IFRS 3 permits early application. The FASB's Investors Technical Advisory Committee and other users of financial statements told the FASB that providing alternatives for when entities adopt a new standard impairs comparability. The IASB observed, however, that the changes to IFRS 3 are less extensive than the changes to SFAS 141. In addition, the IASB observed that IAS 27 is silent on the accounting for changes in controlling ownership interests in a subsidiary and it wanted entities to be able to adopt the guidance in the amended IAS 27 as soon as it is published. Accordingly, the IASB retained the proposal in the 2005 Exposure Draft to permit entities to adopt the revised IFRS 3 early if they so choose.

BC432 The IASB and the FASB also concluded that the revised standards should be applied prospectively. As with most other requirements that relate to particular types of transactions, applying the revised standards retrospectively would not be feasible.

[*] The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The requirements for the subsequent accounting for an acquiree in consolidated financial statements were not changed.

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

(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 in the principal (or most advantageous) market for the 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

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~~ measured using 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~~ measurement is based on ~~an assumed~~ significant inputs that are not observable in the market, which IFRS 13 *Fair Value Measurement* refers to as Level 3 inputs. Key assumptions include a 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~~ measurements are based on significant inputs that are not observable in the market and thus represent a fair value measurement categorised within Level 3 of the fair value hierarchy as described in IFRS 13. Key assumptions include the following:

(a) ~~an assumed~~ a discount rate range of 20–25 per cent;

(b) ~~an assumed~~ a 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~~ measuring 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.

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)]

* IFRS 13 *Fair Value Measurement* (issued in May 2011) defines fair value and contains the requirements for measuring fair value and for disclosing information about fair value measurements. As a result the definition of fair value in IFRSs is identical to the definition in US GAAP (Topic 820 *Fair Value Measurement* in the FASB *Accounting Standards Codification*® codified FASB Statement No. 157).

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]

[*] IFRS 13 (issued in May 2011) defines fair value and contains the requirements for measuring fair value and for disclosing information about fair value measurements. Although the disclosures required by IFRS 13 are not required for IFRS 3, the wording for the disclosures in IFRS 3 has been aligned with the wording in US GAAP (Topic 805 Business Combinations in the *FASB Accounting Standards Codification*® codified FASB Statement No. 141(R)).