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

MEMBERS' HANDBOOK

Update No. 89

(Issued 28 July 2010)

Handbook Improvements only

Document Reference and Title	*Instructions*	*Explanations*
VOLUME II		
Contents of Volume II	Insert the revised pages i and iii. Discard the replaced pages i and iii.	Revised contents pages

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

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

This update 89 covers 11 documents set out below.

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKAS 27 (Revised) *Consolidated and Separate Financial Statements*	Replace the Standard, Basis for Conclusions and Implementation Guidance with revised Standard, Basis for Conclusions and Implementation Guidance	Amendments due to - HKFRS 1 (Revised) - Amendments to HKFRS 1 and HKAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* - HKFRS 9 - *Improvements to HKFRSs 2008*

		- Editorial corrections to comply with IASB license agreement
HKAS 28 *Investments in Associates*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKAS 27 (Revised) - HKFRS 3 (Revised) - HKFRS 9 - *Improvements to HKFRSs 2008*

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

HK(IFRIC)-Int 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*	Replace the Interpretation with revised Interpretation	Amendments due to - HKAS 1 (Revised) - HKAS 23 (Revised) - Editorial corrections to comply with IASB license agreement
HK(IFRIC)-Int 2 *Members' Shares in Co-operative Entities and Similar Instruments*	Replace the Interpretation with revised Interpretation	Amendments due to - Amendments to HKAS 32 and HKAS 1 *Puttable Financial Instruments and Obligations Arising from Liquidation*
HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*	Replace the Interpretation with revised Interpretation	Amendments due to - HKFRS 9 - Editorial corrections to comply with IASB license agreement
HK(IFRIC)-Int 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*	Replace the Interpretation with revised Interpretation	Amendments due to - HKAS 1 (Revised) - HKFRS 9
HK(IFRIC)-Int 7 *Applying the Restatement Approach under HKAS 29* Financial Reporting in Hyperinflationary Economies	Replace the Interpretation with revised Interpretation	Amendments due to - HKAS 1 (Revised) - Editorial corrections to comply with IASB license agreement
HK(IFRIC)-Int 8 *Scope of HKFRS 2*	Replace the Interpretation with revised Interpretation	Amendments due to - Editorial corrections to comply with IASB license agreement

HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives*	Replace the Interpretation with revised Interpretation	Amendments due to - Amendments to HK(IFRIC)-Int 9 and HKAS 39 *Embedded Derivatives* - HKFRS 3 (Revised) - HKFRS 9 - *Improvements to HKFRSs 2009*
HK(IFRIC)-Int 10 *Interim Financial Reporting and Impairment*	Replace the Interpretation with revised Interpretation	Amendments due to - HKAS 1 (Revised) - HKFRS 9
HK(IFRIC)-Int 11 *HKFRS 2 – Group and Treasury Share Transactions*	Replace the Interpretation with revised Interpretation	Amendments due to - Editorial corrections to comply with IASB license agreement -

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Revised ~~December 2008~~July 2010*

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

Hong Kong Accounting Standard 27 (Revised)

Consolidated and Separate Financial Statements

* HKAS 27 (Revised) is applicable for annual periods beginning on or after 1 July 2009. Earlier application is permitted. HKAS 27 (Revised) supersedes HKAS 27 issued in 2004, as amended in 2005 and 2007.

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This revised Standard was issued in March 2008. It supersedes HKAS 27, issued in 2004, as amended in 2005 and 2007.

Introduction

Reasons for revising HKAS 27

IN1 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) revising HKAS 27 is to maintain international convergence arising from the revision of IAS 27 *Consolidated and Separate Financial Statements* by the International Accounting Standards Board (IASB). The HKICPA supported the reasons for revising IAS 27 of the IASB.

The IASB revised IAS 27 *Consolidated and Separate Financial Statements* (IAS 27) in 2003 as part of its project on Improvements to International Accounting Standards. The IASB's main objective was to reduce alternatives in accounting for subsidiaries in consolidated financial statements and in accounting for investments in the separate financial statements of a parent, venturer or investor. The IASB did not reconsider the fundamental approach to consolidation of subsidiaries contained in IAS 27.

IN2 In 2008 the Standard was amended as part of the second phase of the business combinations project. That phase of the project was undertaken jointly with the US Financial Accounting Standards Board (FASB). The amendments related, primarily, to accounting for non-controlling interests and the loss of control of a subsidiary. The IASB and FASB concluded the second phase of the project by the IASB issuing the amended IAS 27 and the FASB issuing FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*, along with, respectively, a revised IFRS 3 *Business Combinations* and FASB Statement No. 141 (revised 2007) *Business Combinations*.

IN3 The amended Standard must be applied for annual periods beginning on or after 1 July 2009. Earlier application is permitted. However, an entity must not apply the amendments for annual periods beginning before 1 July 2009 unless it also applies HKFRS 3 (as revised in 2008).

Main features of the Standard

Objective

IN4 The objective of HKAS 27 is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control. The Standard specifies:

(a) the circumstances in which an entity must consolidate the financial statements of another entity (being a subsidiary);

(b) the accounting for changes in the level of ownership interest in a subsidiary;

(c) the accounting for the loss of control of a subsidiary; and

(d) the information that an entity must disclose to enable users of the financial statements to evaluate the nature of the relationship between the entity and its subsidiaries.

Presentation of consolidated financial statements

IN5 A parent must consolidate its investments in subsidiaries. There is a limited exception available to some non-public entities. However, that exception does not relieve venture capital organisations, mutual funds, unit trusts and similar entities from consolidating their subsidiaries.

Consolidation procedures

IN6 A group must use uniform accounting policies for reporting like transactions and other events in similar circumstances. The consequences of transactions, and balances, between entities within the group must be eliminated.

Non-controlling interests

IN7 Non-controlling interests must be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Total comprehensive income must be 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.

Changes in the ownership interests

IN8 Changes in a parent's ownership interest in a subsidiary that do not result in the loss of control are accounted for within equity.

IN9 When an entity loses control of a subsidiary it derecognises the assets and liabilities and related equity components of the former subsidiary. Any gain or loss is recognised in profit or loss. Any investment retained in the former subsidiary is measured at its fair value at the date when control is lost.

Separate financial statements

IN10 When an entity elects, or is required by local regulations, to present separate financial statements, investments in subsidiaries, jointly controlled entities and associates must be accounted for at cost or in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*.

Disclosure

IN11 An entity must disclose information about the nature of the relationship between the parent entity and its subsidiaries.

Hong Kong Accounting Standard 27
Consolidated and Separate Financial Statements

Scope

1 **This Standard shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.**

2 This Standard does not deal with methods of accounting for business combinations and their effects on consolidation, including goodwill arising on a business combination (see HKFRS 3 *Business Combinations*).

3 **This Standard shall also be applied in accounting for investments in subsidiaries, jointly controlled entities and associates when an entity elects, or is required by local regulations, to present separate financial statements.**

Definitions

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

Consolidated financial statements **are the financial statements of a group presented as those of a single economic entity.**

Control **is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.**

~~**The *cost method* is a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from retained earnings of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.**~~

A *group* is a parent and all its subsidiaries.

Non-controlling interest **is the equity in a subsidiary not attributable, directly or indirectly, to a parent.**

A *parent* is an entity that has one or more subsidiaries.

Separate financial statements **are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.**

A *subsidiary* is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

5 A parent or its subsidiary may be an investor in an associate or a venturer in a jointly controlled entity. In such cases, consolidated financial statements prepared and presented in accordance with this Standard are also prepared so as to comply with HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures*.

6 For an entity described in paragraph 5, separate financial statements are those prepared and presented in addition to the financial statements referred to in paragraph 5. Separate financial statements need not be appended to, or accompany, those statements.

7 The financial statements of an entity that does not have a subsidiary, associate or venturer's interest in a jointly controlled entity are not separate financial statements.

8 A parent that is exempted in accordance with paragraph 10 from presenting consolidated financial statements may present separate financial statements as its only financial statements.

Presentation of consolidated financial statements

9 **A parent, other than a parent described in paragraph 10, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with this Standard.**

10 **A parent need not present consolidated financial statements if and only if [1]:**

(a) **the parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;**

(b) **the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);**

(c) **the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and**

(d) **the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.**

11 A parent that elects in accordance with paragraph 10 not to present consolidated financial statements, and presents only separate financial statements, complies with paragraphs 38–43.

Scope of consolidated financial statements

12 **Consolidated financial statements shall include all subsidiaries of the parent.[2]**

13 Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:[3]

(a) power over more than half of the voting rights by virtue of an agreement with other investors;

(b) power to govern the financial and operating policies of the entity under a statute or an agreement;

(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

14 An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the

[1] Section 124(2) of the Hong Kong Companies Ordinance (CO) permits a holding company not to prepare group accounts if the company is a wholly-owned subsidiary of another company at the end of its financial year. Accordingly, a Hong Kong incorporated parent company can only take advantage of the exemption under paragraph 10 of this Standard if it also satisfies the exemption allowed under Section 124(2) of the CO.

[2] If on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it shall be accounted for in accordance with that HKFRS.

[3] See also HK(SIC)-Int 12 *Consolidation–Special Purpose Entities.*

power to govern the financial and operating policies of another entity. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

15 In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights.

16 A subsidiary is not excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or similar entity.

17 A subsidiary is not excluded from consolidation because its business activities are dissimilar from those of the other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by HKFRS 8 *Operating Segments* help to explain the significance of different business activities within the group.

Consolidation procedures

18 In preparing consolidated financial statements, an entity combines the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single economic entity, the following steps are then taken:

(a) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated (see HKFRS 3, which describes the treatment of any resultant goodwill);

(b) non-controlling interests in the profit or loss of consolidated subsidiaries for the reporting period are identified; and

(c) non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the parent's ownership interests in them. Non-controlling interests in the net assets consist of:

(i) the amount of those non-controlling interests at the date of the original combination calculated in accordance with HKFRS 3; and

(ii) the non-controlling interests' share of changes in equity since the date of the combination.

19 When potential voting rights exist, the proportions of profit or loss and changes in equity allocated to the parent and non-controlling interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights.

20 Intragroup balances, transactions, income and expenses shall be eliminated in full.

21 Intragroup balances and transactions, including income, expenses and dividends, are eliminated in full. Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full. Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. HKAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

22 The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same date. When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.

23 When, in accordance with paragraph 22, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a date different from that of the parent's financial statements, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements. In any case, the difference between the end of the reporting period of the subsidiary and that of the parent shall be no more than three months. The length of the reporting periods and any difference between the ends of the reporting periods shall be the same from period to period.

24 Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

25 If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements.

26 The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date as defined in HKFRS 3. Income and expenses of the subsidiary shall be based on the values of the assets and liabilities recognised in the parent's consolidated financial statements at the acquisition date. For example, depreciation expense recognised in the consolidated statement of comprehensive income after the acquisition date shall be based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date. The income and expenses of a subsidiary are included in the consolidated financial statements until the date when the parent ceases to control the subsidiary.

27 Non-controlling interests shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

28 Profit or loss and each component of other comprehensive income are attributed to the owners of the parent and to the non-controlling interests. 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.

29 If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the parent computes its share of profit or loss after adjusting for the dividends on such shares, whether or not dividends have been declared.

30 Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners).

31 In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.

Loss of control

32 A parent can lose control of a subsidiary with or without a change in absolute or relative ownership levels. This could occur, for example, when a subsidiary becomes subject to the control of a government, court, administrator or regulator. It also could occur as a result of a contractual agreement.

33 A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. One or more of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

(a) They are entered into at the same time or in contemplation of each other.

(b) They form a single transaction designed to achieve an overall commercial effect.

(c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

(d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

34 If a parent loses control of a subsidiary, it:

(a) derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

(b) derecognises the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them);

(c) recognises:

(i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control; and

(ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;

(d) recognises any investment retained in the former subsidiary at its fair value at the date when control is lost;

(e) reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other HKFRSs, the amounts identified in paragraph 35; and

(f) recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.

35 If a parent loses control of a subsidiary, the parent shall account for all amounts recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. For example, if a subsidiary has available-for-sale financial assets and the parent loses control of the subsidiary, the parent shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets. Similarly, if a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent transfers the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

36 On the loss of control of a subsidiary, any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary shall be accounted for in accordance with other HKFRSs from the date when control is lost.

37 The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement* or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

Accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements

38 When an entity prepares separate financial statements ~~are prepared~~, it shall account for investments in subsidiaries, jointly controlled entities and associates ~~that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* shall be accounted for~~ either:

(a) at cost, or

(b) in accordance with HKAS 39.

The entity shall apply the same accounting ~~shall be applied~~ for each category of investments. Investments ~~in subsidiaries, jointly controlled entities and associates that~~ accounted for at cost shall be accounted for in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 ~~shall be accounted for in accordance with that HKFRS~~. The measurement of investments accounted for in accordance with HKAS 39 is not changed in such circumstances.

38A An entity shall recognise a dividend from a subsidiary, jointly controlled entity or associate in profit or loss in its separate financial statements when its right to receive the dividend is established.

38B When a parent reorganises the structure of its group by establishing a new entity as its parent in a manner that satisfies the following criteria:

(a) the new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent;

(b) the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation; and

(c) the owners of the original parent before the reorganisation have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganisation

and the new parent accounts for its investment in the original parent in accordance with paragraph 38(a) in its separate financial statements, the new parent shall measure cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

38C Similarly, an entity that is not a parent might establish a new entity as its parent in a manner that satisfies the criteria in paragraph 38B. The requirements in paragraph 38B apply equally to such reorganisations. In such cases, references to 'original parent' and 'original group' are to the 'original entity'.

39 This Standard does not mandate which entities produce separate financial statements available for public use. Paragraphs 38 and 40–43 apply when an entity prepares separate financial statements that comply with Hong Kong Financial Reporting Standards. The entity also produces consolidated financial statements available for public use as required by paragraph 9, unless the exemption provided in paragraph 10 is applicable.

40 Investments in jointly controlled entities and associates that are accounted for in accordance with HKAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.

Disclosure

41 **The following disclosures shall be made in consolidated financial statements:**

(a) the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;

(b) the reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control;

(c) the end of the reporting period of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a date or for a period that is different from that of the parent's financial statements, and the reason for using a different date or period;

(d) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances;

(e) a schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary that do not result in a loss of control on the equity attributable to owners of the parent; and

(f) if control of a subsidiary is lost, the parent shall disclose the gain or loss, if any, recognised in accordance with paragraph 34, and:

(i) the portion of that gain or loss attributable to recognising any investment retained in the former subsidiary at its fair value at the date when control is lost; and

(ii) the line item(s) in the statement of comprehensive income in which the gain or loss is recognised (if not presented separately in the statement of comprehensive income).

42 **When separate financial statements are prepared for a parent that, in accordance with paragraph 10, elects not to prepare consolidated financial statements, those separate financial statements shall disclose:**

(a) the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards have been produced for public use; and the address where those consolidated financial statements are obtainable;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b).

43 **When a parent (other than a parent covered by paragraph 42), venturer with an interest in a jointly controlled entity or an investor in an associate prepares separate financial statements, those separate financial statements shall disclose:**

(a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b);

and shall identify the financial statements prepared in accordance with paragraph 9 of this Standard or HKAS 28 and HKAS 31 to which they relate.

Effective date and transition

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

45 An entity shall apply the amendments to HKAS 27 made in 2008 in paragraphs 4, 18, 19, 26–37 and 41(e) and (f) for annual periods beginning on or after 1 July 2009. Earlier application is permitted. However, an entity shall not apply these amendments for annual periods beginning before 1 July 2009 unless it also applies HKFRS 3 (as revised in 2008). If an entity applies the amendments before 1 July 2009, it shall disclose that fact. An entity shall apply the amendments retrospectively, with the following exceptions:

(a) the amendment to paragraph 28 for attributing total comprehensive income 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. Therefore, an entity shall not restate any profit or loss attribution for reporting periods before the amendment is applied.

(b) the requirements in paragraphs 30 and 31 for accounting for changes in ownership interests in a subsidiary after control is obtained. Therefore, the requirements in paragraphs 30 and 31 do not apply to changes that occurred before an entity applies the amendments.

(c) the requirements in paragraphs 34–37 for the loss of control of a subsidiary. An entity shall not restate the carrying amount of an investment in a former subsidiary if control was lost before it applies those amendments. In addition, an entity shall not recalculate any gain or loss on the loss of control of a subsidiary that occurred before the amendments are applied.

45A Paragraph 38 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009, prospectively from the date at which it first applied HKFRS 5. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

45B *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 and HKAS 27), issued in October 2008, deleted the definition of the cost method from paragraph 4 and added paragraph 38A. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the changes for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 18, HKAS 21 and HKAS 36 at the same time.

45C *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 38B and 38C. An entity shall apply those paragraphs prospectively to reorganisations occurring in annual periods beginning on or after 1 January 2009. Earlier application is permitted. In addition, an entity may elect to apply paragraphs 38B and 38C retrospectively to past reorganisations within the scope of those paragraphs. However, if an entity restates any reorganisation to comply with paragraph 38B or 38C, it shall restate all later reorganisations within the scope of those paragraphs. If an entity applies paragraph 38B or 38C for an earlier period, it shall disclose that fact.

Withdrawal of HKAS 27 (issued 2004)

46 This Standard supersedes HKAS 27 *Consolidated and Separate Financial Statements* issued in 2004, as amended in 2005 and 2007.

Appendix A
Amendments to other HKFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 July 2009. If an entity applies revised HKAS 27 for an earlier period, these amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix B
Amendments resulting from other HKFRSs

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

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

In paragraph IN10 after the reference to 'HKAS 39 *Financial Instruments: Recognition and Measurement*' is added 'and HKFRS 9 *Financial Instruments*'. Paragraphs 35, 37, 38 and 40 are amended and paragraph 45D is added as follows:

35 If a parent loses control of a subsidiary, … For example, if a subsidiary has cumulative exchange differences relating to a foreign operation ~~available-for-sale financial assets~~ and the parent loses control of the subsidiary, the parent shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to the foreign operation ~~those assets~~. Similarly, …

37 The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with HKFRS 9 *Financial Instruments* ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~ or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

(a) at cost, or

(b) in accordance with HKFRS 9 and HKAS 39.

The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5. The accounting for ~~measurement of~~ investments ~~accounted for~~ in accordance with HKFRS 9 and HKAS 39 is not changed in such circumstances.

40 Investments in jointly controlled entities and associates that are accounted for in accordance with HKFRS 9 and HKAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.

45D HKFRS 9, issued in November 2009, amended paragraphs 35, 37, 38 and 40. An entity shall apply those amendments when it applies HKFRS 9.

Appendix C
Comparison with International Accounting Standards

This comparison appendix, which was prepared in March 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 HKAS 27.

The International Accounting Standard comparable with HKAS 27 is IAS 27 *Consolidated and Separate Financial Statements*.

There are no major textual differences between HKAS 27 and IAS 27.

Basis for Conclusions on IAS 27 *Consolidated and Separate Financial Statements*

This Basis for Conclusions accompanies, but is not part of, IAS 27.

HKAS 27 is based on IAS 27 *Consolidated and Separate Financial Statements*. In approving HKAS 27, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 27. Accordingly, there are no significant differences between HKAS 27 and IAS 27. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 27 referred to below generally correspond with those in HKAS 27.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* in 2003 and on amending IAS 27 *Consolidated and Separate Financial Statements* in 2008. 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 27 (as revised in 2000). The project was undertaken in the light of queries and criticisms raised in relation to the standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an exposure draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the exposure draft. After redeliberating the issues in the light of the comments received, the Board issued a revised IAS 27 in December 2003.

BC3 In July 2001 the Board added a project on business combinations to its agenda. Phase I of the project resulted in the Board issuing in March 2004 IFRS 3 *Business Combinations* and revised versions of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. The second phase of the project was conducted jointly with the US Financial Accounting Standards Board (FASB), and focused primarily on the application of the acquisition method.

BC4 Part of the second phase of the business combinations project was the reconsideration of business combinations in which an acquirer obtains control of a subsidiary through the acquisition of some, but not all, of the equity interests in that subsidiary. In those business combinations, non-controlling interests in the subsidiary exist at the date of the business combination.

BC5 When the Board revised IAS 27 in 2003, it acknowledged that additional guidance was needed on the recognition and measurement of non-controlling interests and the treatment of transactions with non-controlling interests. The Board was aware of diversity in practice in the absence of guidance in IFRSs, with as many as five methods being used to account for acquisitions of non-controlling interests after control is obtained.

BC6 In June 2005 the Board published an exposure draft of proposed amendments to IAS 27 in conjunction with an exposure draft of proposed amendments to IFRS 3 as part of the second phase of the business combinations project. The Board received 95 comment letters on the exposure draft of amendments to IAS 27.

BC7 After redeliberating the issues in the light of the comments received, in 2008 the Board issued a revised IFRS 3 together with an amended version of IAS 27. Close to the same time, the FASB issued Statement No. 141 (revised 2007) *Business Combinations* and Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*, which amended Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51). In developing the amendments, the Board did not reconsider all of the requirements in IAS 27, and the FASB did not discuss all of the requirements of ARB 51. The changes primarily relate to accounting for non-controlling interests and the loss of control of subsidiaries. The boards reached the same conclusions on all of the issues considered jointly.

BC8 Because the Board's intention was not to reconsider the fundamental approach to consolidation established in IAS 27, this Basis for Conclusions does not discuss requirements in IAS 27 that the Board has not reconsidered. The Board is considering the other requirements of IAS 27 as part of its project on consolidation.

Presentation of consolidated financial statements (2003 revision)

Exemption from preparing consolidated financial statements

BC9 Paragraph 7 of IAS 27 (as revised in 2000) required consolidated financial statements to be presented. However, paragraph 8 permitted a parent that is a wholly-owned or virtually wholly-owned subsidiary not to prepare consolidated financial statements. The Board considered whether to withdraw or amend this exemption from the general requirement.

BC10 The Board decided to retain an exemption, so that entities in a group that are required by law to produce financial statements available for public use in accordance with International Financial Reporting Standards, in addition to consolidated financial statements, would not be unduly burdened.

BC11 The Board noted that in some circumstances users can find sufficient information for their purposes regarding a subsidiary from either its separate financial statements or consolidated financial statements. In addition, the users of financial statements of a subsidiary often have, or can get access to, more information.

BC12 Having agreed to retain an exemption, the Board decided to modify the circumstances in which an entity would be exempt and considered the following criteria.

Unanimous agreement of the owners of the minority interests*

BC13 The 2002 exposure draft proposed to extend the exemption to a parent that is not wholly-owned if the owners of the minority interest, including those not otherwise entitled to vote, unanimously agree.

BC14 Some respondents disagreed with the proposal for unanimous agreement of minority shareholders to be a condition for exemption, in particular because of the practical difficulties in obtaining responses from all of those shareholders. The Board decided that the exemption should be available to a parent that is not wholly-owned when the owners of the minority interests have been informed about, and do not object to, consolidated financial statements not being presented.

Exemption available only to non-public entities

BC15 The Board believes that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market are best served when investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IAS 27, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*. The Board therefore decided that the exemption from preparing such consolidated financial statements should not be available to such entities or to entities in the process of issuing instruments in a public market.

BC16 The Board decided that a parent that meets the criteria for exemption from the requirement to prepare consolidated financial statements should, in its separate financial statements, account for those subsidiaries in the same way as other parents, venturers with interests in jointly controlled entities or investors in associates account for investments in their separate financial statements. The Board draws a distinction between accounting for such investments as equity investments and accounting for the economic entity that the parent controls. In relation to the

* IAS 27 (as amended in 2008) changed the term 'minority interest' to 'non-controlling interest'. For further discussion see paragraph BC28.

former, the Board decided that each category of investment should be accounted for consistently.

BC17 The Board decided that the same approach to accounting for investments in separate financial statements should apply irrespective of the circumstances for which they are prepared. Thus, parents that present consolidated financial statements, and those that do not because they are exempted, should present the same form of separate financial statements.

Scope of consolidated financial statements (2003 revision)

Scope exclusions

BC18 Paragraph 13 of IAS 27 (as revised in 2000) required a subsidiary to be excluded from consolidation when control is intended to be temporary or when the subsidiary operates under severe long-term restrictions.

Temporary control

BC19 The Board considered whether to remove this scope exclusion and thereby converge with other standard-setters that had recently eliminated a similar exclusion. The Board decided to consider this issue as part of a comprehensive standard dealing with asset disposals. It decided to retain an exemption from consolidating a subsidiary when there is evidence that the subsidiary is acquired with the intention to dispose of it within twelve months and that management is actively seeking a buyer. The Board's exposure draft ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* proposed to measure and present assets held for sale in a consistent manner irrespective of whether they are held by an investor or in a subsidiary. Therefore, ED 4 proposed to eliminate the exemption from consolidation when control is intended to be temporary and it contained a draft consequential amendment to IAS 27 to achieve this.*

Severe long-term restrictions impairing ability to transfer funds to the parent

BC20 The Board decided to remove the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that impair a subsidiary's ability to transfer funds to the parent. It did so because such circumstances may not preclude control. The Board decided that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent. In themselves, such restrictions do not preclude control.

* In March 2004, the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 removed this scope exclusion and eliminated the exemption from consolidation when control is intended to be temporary. For further discussion see the Basis for Conclusions on IFRS 5.

Venture capital organisations, private equity entities and similar organisations

BC21 The 2002 exposure draft of IAS 27 proposed to clarify that a subsidiary should not be excluded from consolidation simply because the entity is a venture capital organisation, mutual fund, unit trust or similar entity. Some respondents from the private equity industry disagreed with this proposed clarification. They argued that private equity entities should not be required to consolidate the investments they control in accordance with the requirements in IAS 27. They argued that they should measure those investments at fair value. Those respondents raised varying arguments—some based on whether control is exercised, some on the length of time that should be provided before consolidation is required, and some on whether consolidation was an appropriate basis for private equity entities or the type of investments they make.

BC22 Some respondents also noted that the Board decided to exclude venture capital organisations and similar entities from the scope of IASs 28 and 31 when investments in associates or jointly controlled entities are measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. In the view of those respondents, the Board was proposing that similar assets should be accounted for in dissimilar ways.

BC23 The Board did not accept these arguments. The Board noted that those issues are not specific to the private equity industry. It confirmed that a subsidiary should not be excluded from consolidation on the basis of the nature of the controlling entity. Consolidation is based on the parent's ability to control the investee, which captures both the power to control (ie the ability exists but it is not exercised) and actual control (ie the ability is exercised). Consolidation is triggered by control and should not be affected by whether management intends to hold an investment in an entity that it controls for the short term.

BC24 The Board noted that the exception from the consolidation principle in IAS 27 (as revised in 2000), when control of a subsidiary is intended to be temporary, might have been misread or interpreted loosely. Some respondents to the exposure draft had interpreted 'near future' as covering a period of up to five years. The Board decided to remove these words and to restrict the exception to subsidiaries acquired and held exclusively for disposal within twelve months, providing that management is actively seeking a buyer.

BC25 The Board did not agree that it should differentiate between types of entity, or types of investment, when applying a control model of consolidation. It also did not agree that management intention should be a determinant of control. Even if it had wished to make such differentiations, the Board did not see how or why it would be meaningful to distinguish private equity investors from other types of entities.

BC26 The Board believes that the diversity of the investment portfolios of entities operating in the private equity sector is not different from the diversification of portfolios held by a conglomerate, which is an industrial group made up of entities that often have diverse and unrelated interests. The Board acknowledged that financial information about an entity's different types of products and services and its operations in different geographical areas—segment information—is relevant to assessing the risks and returns of a diversified or multinational entity and may not be determinable from the aggregated data presented in the consolidated balance sheet.[*] The Board noted that IAS 14 *Segment Reporting* establishes principles for reporting segment information by entities whose equity or debt instruments are publicly traded, or any entity that discloses segment information voluntarily.[♦]

BC27 The Board concluded that for investments under the control of private equity entities, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control. The Board noted that a parent can either present information about the fair value of those investments in the notes to the consolidated financial statements or prepare separate financial statements in addition to its consolidated financial statements, presenting those investments at cost or at fair value. By contrast, the Board decided that information needs of users of financial statements would not be well served if those controlling investments were measured only at fair value. This would leave unreported the assets and liabilities of a controlled entity. It is conceivable that an investment in a large, highly geared subsidiary would have only a small fair value. Reporting that value alone would preclude a user from being able to assess the financial position, results

[*] IAS 1 *Presentation of Financial Statements* (as revised in 2007) replaced the term 'balance sheet' with 'statement of financial position'.

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

and cash flows of the group.

Non-controlling interests (2003 revision and 2008 amendments)

BC28 The 2008 amendments to IAS 27 changed the term 'minority interest' to 'non-controlling interest'. The change in terminology reflects the fact that the owner of a minority interest in an entity might control that entity and, conversely, that the owners of a majority interest might not control the entity. 'Non-controlling interest' is a more accurate description than 'minority interest' of the interests of those owners who do not have a controlling interest in an entity.

BC29 Non-controlling interest is defined in IAS 27 as the equity in a subsidiary not attributable, directly or indirectly, to a parent. Paragraph 26 of IAS 27 (as revised in 2000) required minority (non-controlling) interests to be presented in the consolidated balance sheet separately from liabilities and the equity of the shareholders of the parent.

BC30 As part of the 2003 revision of IAS 27, the Board decided to amend this requirement to require minority (non-controlling) interests to be presented in the consolidated balance sheet within equity, separately from the equity of the shareholders of the parent. The Board concluded that a minority (non-controlling) interest is not a liability of a group because it does not meet the definition of a liability in the *Framework for the Preparation and Presentation of Financial Statements*.

BC31 Paragraph 49(b) of the *Framework* states that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Paragraph 60 of the *Framework* further indicates that an essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The Board noted that the existence of a minority (non-controlling) interest in the net assets of a subsidiary does not give rise to a present obligation of the group, the settlement of which is expected to result in an outflow of economic benefits from the group.

BC32 Rather, the Board noted that minority (non-controlling) interests represent the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group, and therefore meet the *Framework*'s definition of equity. Paragraph 49(c) of the *Framework* states that equity is the residual interest in the assets of the entity after deducting all of its liabilities.

Attribution of losses (2008 amendments)

BC33 IAS 27 (as revised in 2003) stated that when losses attributed to the minority (non-controlling) interests exceed the minority's interests in the subsidiary's equity the excess, and any further losses applicable to the minority, is allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses.

BC34 The Board decided that this treatment was inconsistent with its conclusion that non-controlling interests are part of the equity of the group and proposed that an entity should attribute total comprehensive income applicable to non-controlling interests to them, even if this results in the non-controlling interests having a deficit balance.

BC35 If the parent enters into an arrangement that places it under an obligation to the subsidiary or to the non-controlling interests, the Board believes that the entity should account for that arrangement separately and the arrangement should not affect the way the entity attributes comprehensive income to the controlling and non-controlling interests.

BC36 Some respondents to the 2005 exposure draft agreed with the proposal, noting that non-controlling interests share proportionately in the risks and rewards of the investment in the subsidiary and that the proposal is consistent with the classification of non-controlling interests as equity.

BC37 Other respondents disagreed with the proposal, often on the grounds that controlling and non-controlling interests have different characteristics and should not be treated the same way. Those respondents argued that there was no need to change the guidance in IAS 27 (as revised in 2003) (ie that an entity should allocate excess losses to the controlling interest unless the non-controlling interests have a binding obligation and are able to make an additional investment to cover the losses). The reasons offered by those respondents were:

(a) The non-controlling interests are not compelled to cover the deficit (unless they have otherwise specifically agreed to do so) and it is reasonable to assume that, should the subsidiary require additional capital in order to continue operations, the non-controlling interests would abandon their investments. In contrast, respondents asserted that in practice the controlling interest often has an implicit obligation to maintain the subsidiary as a going concern.

(b) Often guarantees or other support arrangements by the parent, without any effect on the way losses are attributed to the controlling and non-controlling interests, protect the non-controlling interests from losses of the subsidiary in excess of equity. Respondents believe that allocating those losses to the parent and non-controlling interests and recognising separately a guarantee would not reflect the underlying economics, which are that only the parent absorbs the losses of the subsidiary. In their view, it is misleading for financial statements to imply that the non-controlling interests have an obligation to make additional investments.

(c) Recognising guarantees separately is contrary to the principle of the non-recognition of transactions between owners.

(d) Loss allocation should take into account legal, regulatory or contractual constraints, some of which may prevent entities from recognising negative non-controlling interests, especially for regulated businesses (eg banks and insurers).

BC38 The Board considered these arguments but observed that, although it is true that non-controlling interests have no further obligation to contribute assets to the subsidiary, neither does the parent. Non-controlling interests participate proportionally in the risks and rewards of an investment in the subsidiary.

BC39 Some respondents asked the Board to provide guidance on the accounting for guarantees and similar arrangements between the parent and the subsidiary or the non-controlling interests. They also suggested that the Board should require additional disclosures about inter-company guarantees and the extent of deficits, if any, of non-controlling interests.

BC40 The Board considered these requests but observed that this is an issue that is wider than negative non-controlling interests. Similarly, the parent is not necessarily responsible for the liabilities of a subsidiary, and often there are factors that restrict the ability of a parent entity to move assets around in a group, which means that the assets of the group are not necessarily freely available to that entity. The Board decided that it would be more appropriate to address comprehensively disclosures about non-controlling interests.

Changes in ownership interests in subsidiaries (2008 amendments)

BC41 The Board decided that after control of an entity is obtained, changes in a parent's ownership interest that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners). This means that no gain or loss from these changes should be recognised in profit or loss. It also means that no change in the carrying amounts of the subsidiary's assets (including goodwill) or liabilities should be recognised as a result of such transactions.

BC42 The Board reached this conclusion because it believes that the approach adopted in these amendments is consistent with its previous decision that non-controlling interests are a separate component of equity (see paragraphs BC29–BC32).

BC43 Some respondents agreed that non-controlling interests are equity but stated that they should be treated as a special class of equity. Other respondents disagreed with the requirement because they believe that recognising transactions with non-controlling interests as equity transactions means that the Board has adopted an entity approach whereas the respondents prefer a proprietary approach. The Board disagreed with this characterisation of the accounting treatment, noting that the accounting proposed is a consequence of classifying non-controlling interests as equity. The Board did not consider comprehensively the entity and proprietary approaches as part of the amendments to IAS 27 in 2008.

BC44 Many respondents to the 2005 exposure draft suggested alternative approaches for the accounting for changes in controlling ownership interests. The most commonly suggested alternative would result in increases in controlling ownership interests giving rise to the recognition of additional goodwill, measured as the excess of the purchase consideration over the carrying amount of the separately identified assets in the subsidiary attributable to the additional interest acquired.

BC45 Some respondents suggested that when an entity reduces its ownership interest in a subsidiary, without losing control, it should recognise a gain or loss attributable to the controlling interest. They would measure that gain or loss as the difference between the consideration received and the proportion of the carrying amount of the subsidiary's assets (including recognised goodwill) attributable to the ownership interest being disposed of. Respondents supporting this alternative believed that it would provide relevant information about the gains and losses attributable to the controlling interest arising on the partial disposal of ownership interests in subsidiaries.

BC46 The Board rejected this alternative. Recognising a change in any of the assets of the business, including goodwill, is inconsistent with the Board's decision in IFRS 3 (as revised in 2008) that obtaining control in a business combination is a significant economic event. That event causes the initial recognition and measurement of all the assets acquired and liabilities assumed in the business combination. Subsequent transactions with owners should not affect the measurement of those assets and liabilities.

BC47 The parent already controls the assets of the business, although it must share the income from those assets with the non-controlling interests. By acquiring the non-controlling interests the parent is obtaining the rights to some, or all, of the income to which the non-controlling interests previously had rights. Generally, the wealth-generating ability of those assets is unaffected by the acquisition of the non-controlling interests. That is to say, the parent is not investing in more or new assets. It is acquiring more rights to the income from the assets it already controls.

BC48 By acquiring some, or all, of the non-controlling interests the parent will be allocated a greater proportion of the profits or losses of the subsidiary in periods after the additional interests are acquired. The adjustment to the controlling interest will be equal to the unrecognised share of the value changes that the parent will be allocated when those value changes are recognised by the subsidiary. Failure to make that adjustment will cause the controlling interest to be overstated.

BC49 The Board noted that accounting for changes in controlling ownership interests as equity transactions, as well as ensuring that the income of the group and the reported controlling interests are faithfully represented, is less complex than the other alternatives considered.

BC50 Some respondents disagreed with the proposal because they were concerned about the effect on reported equity of the subsequent acquisition of non-controlling interests by the parent. Those respondents seemed to be particularly concerned about the effect on the reported leverage of an entity that acquires non-controlling interests and whether this might, for example, cause those entities to have to renegotiate loan agreements.

BC51 The Board observed that all acquisitions of an entity's equity reduce the entity's equity, regardless of whether it is an acquisition of the parent's ordinary or preference shares or non-controlling interests. Hence, the treatment of a subsequent acquisition of non-controlling interests is consistent with the general accounting for the acquisition by an entity of instruments classified as equity.

BC52 The Board understands the importance of providing owners of the parent with information about the total changes in their reported equity. Therefore, the Board decided to require entities to present in a separate schedule the effects of any changes in a parent's ownership interest in a subsidiary that do not result in a loss of control on the equity attributable to owners of the parent.

Loss of control (2008 amendments)

BC53 A parent loses control of a subsidiary when it loses the power to govern the financial and operating policies of an investee so as to obtain benefit from its activities. Loss of control can result from the sale of an ownership interest or by other means, such as when a subsidiary issues new ownership interests to third parties. Loss of control can also occur in the absence of a transaction. It may, for example, occur on the expiry of an agreement that previously allowed an entity to control a subsidiary.

BC54 On loss of control, the parent-subsidiary relationship ceases to exist. The parent no longer controls the subsidiary's individual assets and liabilities. Therefore, the parent derecognises the individual assets, liabilities and equity related to that subsidiary. Equity includes any non-controlling interests as well as amounts previously recognised in other comprehensive income in relation to, for example, available-for-sale financial instruments and foreign currency translation.

BC55 The Board decided that any investment the parent has in the former subsidiary after control is lost should be measured at fair value at the date that control is lost and that any resulting gain or loss should be recognised in profit or loss. Some respondents disagreed with that decision. Those respondents asserted that the principles for revenue and gain recognition in the *Framework* would not be satisfied for the retained interest. The Board disagreed with those respondents. Measuring the investment at fair value reflects the Board's view that the loss of control of a subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.

BC56 The Board decided that the loss of control of a subsidiary is, from the group's perspective, the loss of control over some of the group's individual assets and liabilities. Accordingly, the general requirements in IFRSs should be applied in accounting for the derecognition from the group's financial statements of the subsidiary's assets and liabilities. If a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the separate disposal of those assets and liabilities, the parent reclassifies the gain or loss from equity to profit or loss on the indirect disposal of those assets and liabilities through loss of control of a subsidiary. For example, if a subsidiary sells one of its available-for-sale financial assets in a separate transaction, a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss. Similarly, on the loss of control of a subsidiary, the entire gain or loss attributed to the parent on that former subsidiary's available-for-sale financial assets previously recognised in other comprehensive income would be reclassified to profit or loss.

BC57 The Board also discussed the accounting when an entity transfers its shares in a subsidiary to its own shareholders with the result that the entity loses control of the subsidiary (commonly referred to as a spin-off). The International Financial Reporting Interpretations Committee had previously discussed this matter, but decided not to take it on to its agenda while the business combinations project was in progress. The Board observed that the issue is outside the scope of the business combinations project. Therefore, the Board decided not to address the measurement basis of distributions to owners in the amendments to IAS 27.

Multiple arrangements

BC58 The Board considered whether its decision that a gain or loss on the disposal of a subsidiary should be recognised only when that disposal results in a loss of control could give rise to opportunities to structure transactions to achieve a particular accounting outcome. For example, would an entity be motivated to structure a transaction or arrangement as multiple steps to maximise gains or minimise losses if an entity was planning to dispose of its controlling interest in a subsidiary? Consider the following example. Entity P controls 70 per cent of entity S. P intends to sell all of its 70 per cent controlling interest in S. P could initially sell 19 per cent of its ownership interest in S without loss of control and then, soon afterwards, sell the remaining 51 per cent and lose control. Alternatively, P could sell all of its 70 per cent interest in S in one transaction. In the first case, any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration received on the sale of the 19 per cent interest would be recognised directly in equity, whereas the gain or loss from the sale of the remaining 51 per cent interest would be recognised in profit or loss. In the second case, a gain or loss on the sale of the whole 70 per cent interest would be recognised in profit or loss.

BC59 The Board noted that the opportunity to conceal losses through structuring would be reduced by the requirements of IAS 36 and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Paragraph 12 of IAS 36 includes significant changes in how an entity uses or expects to use an asset as one of the indicators that the asset might be impaired.

BC60 Once an asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale), it is excluded from the scope of IAS 36 and is accounted for in accordance with IFRS 5. In accordance with paragraph 20 of IFRS 5 'an entity shall recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell …'. Therefore, if appropriate, an impairment loss would be recognised for the goodwill and non-current assets of a subsidiary that will be sold or otherwise disposed of before control of the subsidiary is lost. Accordingly, the Board concluded that the principal risk is the minimising of gains, which entities are unlikely to strive to do.

BC61 The Board decided that the possibility of such structuring could be overcome by requiring entities to consider whether multiple arrangements should be accounted for as a single transaction to ensure that the principle of faithful representation is adhered to. The Board believes that all of the terms and conditions of the arrangements and their economic effects should be considered in determining whether multiple arrangements should be accounted for as a single arrangement. Accordingly, the Board included indicators in paragraph 33 to assist in identifying when multiple arrangements that result in the loss of control of a subsidiary should be treated as a single arrangement.

BC62 Some respondents disagreed with the indicators that were provided in the exposure draft. Some respondents stated that the need for guidance on when multiple arrangements should be accounted for as a single arrangement indicates a conceptual weakness in the accounting model developed in the exposure draft. They also stated that such guidance would be unnecessary under other alternatives for accounting for decreases in ownership interests. The Board acknowledges that guidance on multiple arrangements would be unnecessary under some of the other accounting alternatives. However, the Board believes that this does not mean that those models are conceptually superior.

BC63 Some respondents suggested that IAS 27 should include examples rather than indicators for when multiple transactions should be treated as a single transaction or arrangement, but that those examples should not be considered a complete list. The Board considered that suggestion, but decided to affirm the indicators that were in the exposure draft. The Board believed that the indicators could be applied to a variety of situations and are preferable to providing what could be an endless list of examples to try to capture every possible arrangement.

Loss of significant influence or joint control

BC64 The Board observed that the loss of control of a subsidiary, the loss of significant influence over an associate and the loss of joint control over a jointly controlled entity are economically similar events; thus they should be accounted for similarly. The loss of control as well as the loss of significant influence or joint control represents a significant economic event that changes the nature of an investment. Therefore, the Board concluded that the accounting guidance on the loss of control of a subsidiary should be extended to events or transactions in which an investor loses significant influence over an associate or joint control over a jointly controlled entity. Thus, the investor's investment after significant influence or joint control is lost should be recognised and measured initially at fair value and the amount of any resulting gain or loss should be recognised in profit or loss. Therefore, the Board decided to amend IAS 21 *The Effects of Changes in Foreign Exchange Rates*, IAS 28 and IAS 31, accordingly. The FASB considered whether to address that same issue as part of this project. The FASB concluded that the accounting for investments that no longer qualify for equity method accounting was outside the scope of the project.

Measurement of investments in subsidiaries, jointly controlled entities and associates in separate financial statements (2003 revision and 2008 amendments)

BC65 Paragraph 29 of IAS 27 (as revised in 2000) permitted investments in subsidiaries to be measured in any one of three ways in a parent's separate financial statements. These were cost, the equity method, or as available-for-sale financial assets in accordance with IAS 39. Paragraph 12 of IAS 28 (as revised in 2000) permitted the same choices for investments in associates in separate financial statements, and paragraph 38 of IAS 31 (as revised in 2000) mentioned that IAS 31 did not indicate a preference for any particular treatment for accounting for interests in jointly controlled entities in a venturer's separate financial statements. The Board decided to require use of cost or IAS 39 for all investments included in separate financial statements.

BC66 Although the equity method would provide users with some profit and loss information similar to that obtained from consolidation, the Board noted that such information is reflected in the investor's economic entity financial statements and does not need to be provided to the users of its separate financial statements. For separate statements, the focus is upon the performance of the assets as investments. The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39 or the cost method would be relevant. Using the fair value method in accordance with IAS 39 would provide a measure of the economic value of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. For example, they may be needed only by particular parties to determine the dividend income from subsidiaries.

BC66A As part of its annual improvements project begun in 2007, the Board identified an apparent inconsistency with IFRS 5. The inconsistency relates to the accounting by a parent in its separate financial statements when investments it accounts for in accordance with IAS 39 are classified as held for sale in accordance with IFRS 5. Paragraph 38 requires an entity that prepares separate financial statements to account for such investments that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5. However, financial assets that an entity accounts for in accordance with IAS 39 are excluded from IFRS 5's measurement requirements.

BC66B Paragraph BC13 of the Basis for Conclusions on IFRS 5 explains that the Board decided that non-current assets should be excluded from the measurement scope of IFRS 5 only 'if (i) they are already carried at fair value with changes in fair value recognised in profit or loss or (ii) there would be difficulties in determining their fair value less costs to sell.' The Board acknowledged in the Basis for Conclusions on IFRS 5 that not all financial assets within the scope of IAS 39 are recognised at fair value with changes in fair value recognised in profit or loss, but it did not want to make any further changes to the accounting for financial assets at that time.

BC66C Therefore, the Board amended paragraph 38 by *Improvements to IFRSs* issued in May 2008 to align the accounting in separate financial statements for those investments that are accounted for in accordance with IAS 39 with the measurement exclusion that IFRS 5 provides for other assets that are accounted for in accordance with IAS 39 before classification as held for sale. Thus, an entity should continue to account for such investments in accordance with IAS 39

when they meet the held for sale criteria in IFRS 5.

Dividend received from a subsidiary, jointly controlled entity or associate

BC66D Before *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* was issued in May 2008, IAS 27 described a 'cost method'. This required an entity to recognise distributions as income only if they came from post-acquisition retained earnings. 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. To apply that method retrospectively upon first-time adoption of IFRSs in its separate financial statements, an investor would need to know the subsidiary's pre-acquisition retained earnings in accordance with IFRSs.

BC66E Restating pre-acquisition retained earnings would be a task tantamount to restating the business combination (for which IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides an exemption in Appendix B).* It might involve subjective use of hindsight, which would diminish the relevance and reliability of the information. In some cases, the restatement would be time-consuming and difficult. In other cases, it would be impossible (because it would involve making judgements about the fair values of the assets and liabilities of a subsidiary at the acquisition date).

BC66F Therefore, in *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1 (published in January 2007), the Board proposed to give first-time adopters an exemption from restating the retained earnings of the subsidiary at the date of acquisition for the purpose of applying the cost method.

BC66G In considering the responses to that exposure draft, the Board observed that the principle underpinning the cost method is that a return of an investment should be deducted from the carrying amount of the investment. However, the wording in the previous version of IAS 27 created a problem in some jurisdictions because it made specific reference to retained earnings as the means of making that assessment. The Board determined that the best way to resolve this issue was to delete the definition of the cost method.

BC66H In removing the definition of the cost method, the Board concluded that an investor should recognise a dividend from a subsidiary, jointly controlled entity or associate as income in its separate financial statements. Consequently, the requirement to separate the retained earnings of an entity into pre-acquisition and post-acquisition components as a method for assessing whether a dividend is a recovery of its associated investment has been removed from IFRSs.

BC66I To reduce the risk that removing the definition of the cost method would lead to investments in subsidiaries, jointly controlled entities and associates being overstated in the separate financial statements of the investor, the Board proposed that the related investment should be tested for impairment in accordance with IAS 36.

BC66J 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 IAS 27, except for the proposal to require impairment testing of the related investment when an investor recognises a dividend. In the light of the comments received, the Board revised its proposal and identified specific indicators of impairment. This was done to narrow the circumstances under which impairment testing of the related investment would be required when an investor recognises a dividend (see paragraph 12(h) of IAS 36). The Board included the amendments in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* issued in May 2008.

Measurement of cost in the separate financial statements of a new parent

BC66K In 2007 the Board received enquiries about the application of paragraph 38(a) when a parent reorganises the structure of its group by establishing a new entity as its parent. The new parent

* As a result of the revision of IFRS 1 *First-time Adoption of International Financial Reporting Standards* in November 2008, Appendix B became Appendix C.

obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent.

BC66L In this type of reorganisation, the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation. In addition, the owners of the original parent have the same relative and absolute interests in the net assets of the new group immediately after the reorganisation as they had in the net assets of the original group before the reorganisation. Finally, this type of reorganisation involves an existing entity and its shareholders agreeing to create a new parent between them. In contrast, many transactions or events that result in a parent–subsidiary relationship are initiated by a parent over an entity that will be positioned below it in the structure of the group.

BC66M Therefore, the Board decided that in applying paragraph 38(a) *in the limited circumstances in which a parent establishes a new parent in this particular manner*, the new parent should measure the cost of its investment in the original parent at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation. In December 2007 the Board published an exposure draft proposing to amend IAS 27 to add a paragraph with that requirement.

BC66N In response to comments received from respondents to that exposure draft, the Board modified the drafting of the amendment (paragraphs 38B and 38C of the Standard) to clarify that it applies to the following types of reorganisations when they satisfy the criteria specified in the amendment:

(a) reorganisations in which the new parent does not acquire all of the equity instruments of the original parent. For example, a new parent might issue equity instruments in exchange for ordinary shares of the original parent, but not acquire the preference shares of the original parent. In addition, a new parent might obtain control of the original parent, but not acquire all of the ordinary shares of the original parent.

(b) the establishment of an intermediate parent within a group, as well as the establishment of a new ultimate parent of a group.

(c) reorganisations in which an entity that is not a parent establishes a new entity as its parent.

BC66O In addition, the Board clarified that the amendment focuses on the measurement of one asset—the new parent's investment in the original parent in the new parent's separate financial statements. The amendment does not apply to the measurement of any other assets or liabilities in the separate financial statements of either the original parent or the new parent or in the consolidated financial statements.

BC66P The Board included the amendment in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* issued in May 2008.

BC66Q The Board did not consider the accounting for other types of reorganisations or for common control transactions more broadly. Accordingly, paragraphs 38B and 38C apply only when the criteria in those paragraphs are satisfied. Therefore, the Board expects that entities would continue to account for transactions that do not satisfy the criteria in paragraphs 38B and 38C in accordance with their accounting policies for such transactions. The Board plans to consider the definition of common control and the accounting for business combinations under common control in its project on common control transactions.

Disclosure (2008 amendments)

BC67 In considering the 2008 amendments to IAS 27 the Board discussed whether any additional disclosures were necessary. The Board decided that the amount of any gain or loss arising on the loss of control of a subsidiary, including the portion of the gain or loss attributable to recognising any investment retained in the former subsidiary at its fair value at the date when control is lost, and the line item in the statement of comprehensive income in which the gains or losses are recognised should be disclosed. This disclosure will provide information about the effect of the loss of control of a subsidiary on the financial position at the end of, and performance for, the reporting period.

BC68 In its deliberations in the second phase of the business combinations project, the FASB decided to require entities with one or more partially-owned subsidiaries to disclose in the notes to the consolidated financial statements a schedule showing the effects on the controlling interest's equity of changes in a parent's ownership interest in a subsidiary that do not result in a loss of control.

BC69 In the 2005 exposure draft, the Board did not propose to require this disclosure. The Board noted that IFRSs require this information to be provided in the statement of changes in equity or in the notes to the financial statements. This is because IAS 1 *Presentation of Financial Statements* requires an entity to present, within the statement of changes in equity, a reconciliation between the carrying amount of each component of equity at the beginning and end of the period, disclosing separately each change.

BC70 Many respondents to the 2005 exposure draft requested more prominent disclosure of the effects of transactions with non-controlling interests on the equity of the owners of the parent. Therefore, the Board decided to converge with the FASB's disclosure requirement and to require that if a parent has equity transactions with non-controlling interests, it should disclose in a separate schedule the effects of those transactions on the equity of the owners of the parent.

BC71 The Board understands that some users will be interested in information pertaining only to the owners of the parent. The Board expects that the presentation and disclosure requirements of IAS 27, as revised, will meet their information needs.

Transitional provisions (2008 amendments)

BC72 To improve the comparability of financial information across entities, amendments to IFRSs are usually applied retrospectively. Therefore, the Board proposed in its 2005 exposure draft to require retrospective application of the amendments to IAS 27, on the basis that the benefits of retrospective application outweigh the costs. However, in the 2005 exposure draft the Board identified two circumstances in which it concluded that retrospective application would be impracticable:

(a) accounting for increases in a parent's ownership interest in a subsidiary that occurred before the effective date of the amendments. Therefore, the accounting for any previous increase in a parent's ownership interest in a subsidiary before the effective date of the amendments should not be adjusted.

(b) accounting for a parent's investment in a former subsidiary over which control was lost before the effective date of the amendments. Therefore, the carrying amount of any investment in a former subsidiary should not be adjusted to its fair value on the date when control was lost. In addition, an entity should not recalculate any gain or loss on loss of control of a subsidiary if the loss of control occurred before the effective date of the amendments.

BC73 The Board concluded that the implementation difficulties and costs associated with applying the amendments retrospectively in these circumstances outweigh the benefit of improved comparability of financial information. Therefore, the Board decided to require prospective application. In addition, the Board concluded that identifying those provisions for which retrospective application of the amendments would be impracticable, and thus prospective application would be required, would reduce implementation costs and result in greater comparability between entities.

BC74 Some respondents were concerned that the transitional provisions were different for increases and decreases in ownership interests. They argued that accounting for decreases in non-controlling interests retrospectively imposes compliance costs that are not justifiable, mainly because the requirement to account for increases prospectively reduces comparability anyway. The Board accepted those arguments and decided that prospective application would be required for all changes in ownership interests. The revised transitional provisions mean that increases and decreases in ownership interests will be treated symmetrically and that recasting of financial statements is limited to disclosure and presentation. The recognition and measurement of previous transactions will not be changed upon transition.

BC75 In response to practical concerns raised by respondents, the Board also decided to require prospective application of the requirement to allocate losses in excess of the non-controlling interests in the equity of a subsidiary to the non-controlling interests, even if that would result in the non-controlling interests being reported as a deficit.

Appendix A

Amendments to the Basis for Conclusions on other HKFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs accompanying the equivalent converged HKFRSs that are necessary in order to ensure consistency with the revised IAS 27. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

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

Appendix B

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IAS 27 is amended as described below.

In paragraph BC22 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

* In November 2009 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*.

In paragraphs BC65–BC66C the references to IAS 39 are footnoted as follows:

BC65 Paragraph 29 of IAS 27 (as revised in 2000) permitted investments in subsidiaries to be measured in any one of three ways in a parent's separate financial statements. These were cost, the equity method or as available-for-sale financial assets in accordance with IAS 39*. Paragraph 12 of IAS 28 (as revised in 2000) permitted the same choices for investments in associates in separate financial statements, and paragraph 38 of IAS 31 (as revised in 2000) mentioned that IAS 31 did not indicate a preference for any particular treatment for accounting for interests in jointly controlled entities in a venturer's separate financial statements. The Board decided to require use of cost or IAS 39‡ for all investments included in separate financial statements.

BC66 Although the equity method would provide users with some profit and loss information similar to that obtained from consolidation, the Board noted that such information is reflected in the investor's economic entity financial statements and does not need to be provided to the users of its separate financial statements. For separate statements, the focus is upon the performance of the assets as investments. The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39‡ or the cost method would be relevant. Using the fair value method in accordance with IAS 39‡ would provide a measure of the economic value of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. For example, they may be needed only by particular parties to determine the dividend income from subsidiaries.

BC66A As part of its annual improvements project begun in 2007, the Board identified an apparent inconsistency with IFRS 5. The inconsistency relates to the accounting by a parent in its separate financial statements when investments it accounts for in accordance with IAS 39‡ are classified as held for sale in accordance with IFRS 5. Paragraph 38 requires an entity that prepares separate financial statements to account for such investments that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5. However, financial assets that an entity accounts for in accordance with IAS 39‡ are excluded from IFRS 5's measurement requirements.

BC66B Paragraph BC13 of the Basis for Conclusions on IFRS 5 explains that the Board decided that non-current assets should be excluded from the measurement scope of IFRS 5 only 'if (i) they are already carried at fair value with changes in fair value recognised in profit or loss or (ii) there would be difficulties in determining their fair value less costs to sell.' The Board acknowledged in the Basis for Conclusions on IFRS 5 that not all financial assets within the scope of IAS 39‡ are recognised at fair

value with changes in fair value recognised in profit or loss, but it did not want to make any further changes to the accounting for financial assets at that time.

BC66C Therefore, the Board amended paragraph 38 by *Improvements to IFRSs* issued in May 2008 to align the accounting in separate financial statements for those investments that are accounted for in accordance with IAS 39[‡] with the measurement exclusion that IFRS 5 provides for other assets that are accounted for in accordance with IAS 39 before classification as held for sale. Thus, an entity should continue to account for such investments in accordance with IAS 39 when they meet the held for sale criteria in IFRS 5.

* IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

† In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*.

BCA12 In the dissenting opinions on the amendments issued in May 2008, the references to IAS 39 are footnoted as follows:

DO3 These Board members acknowledge that a new parent could choose to apply paragraph 38(b) of IAS 27 and account for its investment in the original parent in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.[‡] However, the new parent then would be required to account for the investment in accordance with IAS 39[‡] in subsequent periods and to account for all other investments in the same category in accordance with IAS 39[‡].

†In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*.

Dissenting opinions on IAS 27

Dissent of Tatsumi Yamada from IAS 27 (as revised in 2003)

DO1 Mr Yamada dissents from this Standard because he believes that the change in classification of minority interests in the consolidated balance sheet, that is to say, the requirement that it be shown as equity, should not be made as part of the Improvements project. He agrees that minority interests do not meet the definition of a liability under the *Framework for the Preparation and Presentation of Financial Statements*, as stated in paragraph BC31 of the Basis for Conclusions, and that the current requirement, for minority interests to be presented separately from liabilities and the parent shareholders' equity, is not desirable. However, he does not believe that this requirement should be altered at this stage. He believes that before making the change in classification, which will have a wide variety of impacts on current consolidation practices, various issues related to this change need to be considered comprehensively by the Board. These include consideration of the objectives of consolidated financial statements and the accounting procedures that should flow from those objectives. Even though the Board concluded as noted in paragraph BC27, he believes that the decision related to the classification of minority interests should not be made until such a comprehensive consideration of recognition and measurement is completed.*

DO2 Traditionally, there are two views of the objectives of consolidated financial statements; they are implicit in the parent company view and the economic entity view. Mr Yamada believes that the objectives, that is to say, what information should be provided and to whom, should be considered by the Board before it makes its decision on the classification of minority interests in IAS 27. He is of the view that the Board is taking the economic entity view without giving enough consideration to this fundamental issue.

DO3 Step acquisitions are being discussed in the second phase of the Business Combinations project, which is not yet finalised at the time of finalising IAS 27 under the Improvements project. When the ownership interest of the parent increases, the Board has tentatively decided that the difference between the consideration paid by the parent to minority interests and the carrying value of the ownership interests acquired by the parent is recognised as part of equity, which is different from the current practice of recognising a change in the amount of goodwill. If the parent retains control of a subsidiary but its ownership interest decreases, the difference between the consideration received by the parent and the carrying value of the ownership interests transferred is also recognised as part of equity, which is different from the current practice of recognising a gain or a loss. Mr Yamada believes that the results of this discussion are predetermined by the decision related to the classification of minority interests as equity. The changes in accounting treatments are fundamental and he believes that the decision on which of the two views should govern the consolidated financial statements should be taken only after careful consideration of the ramifications. He believes that the amendment of IAS 27 relating to the classification of minority interests should not be made before completion of the second phase of the Business Combinations project.

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* Paragraph BC27 of IAS 27 (as revised in 2003) was deleted as part of the 2008 amendments to IAS 27. That paragraph stated:

> The Board acknowledged that this decision gives rise to questions about the recognition and measurement of minority interests but it concluded that the proposed presentation is consistent with current standards and the *Framework* and would provide better comparability than presentation in the consolidated balance sheet with either liabilities or parent shareholders' equity. It decided that the recognition and measurement questions should be addressed as part of its project on business combinations.

Dissent of Philippe Danjou, Jan Engstrom, Robert P Garnett, Gilbert Gelard and Tatsumi Yamada from the amendments to IAS 27 issued in January 2008 on the accounting for non-controlling interests and the loss of control of a subsidiary

DO1 Messrs Danjou, Engstrom, Garnett, Gelard and Yamada dissent from the 2008 amendments to IAS 27.

Accounting for changes in ownership interests in a subsidiary

DO2 Messrs Danjou, Engstrom, Gelard and Yamada do not agree that acquisitions of non-controlling interests in a subsidiary by the parent should be accounted for in full as equity transactions.

DO3 Those Board members observe that the consideration paid for an additional interest in a subsidiary will reflect the additional interest's share in:

(a) the carrying amount of the subsidiary's net assets at that date;

(b) additionally acquired goodwill; and

(c) unrecognised increases in the fair value of the subsidiary's net assets (including goodwill) since the date when control was obtained.

DO4 Paragraphs 30 and 31 of the Standard require such a transaction to be accounted for as an equity transaction, by adjusting the relative interests of the parent and the non-controlling interests. As a consequence, the additionally acquired goodwill and any unrecognised increases in the fair value of the subsidiary's net assets would be deducted from equity. Those Board members disagree that such accounting faithfully represents the economics of such a transaction.

DO5 Those Board members believe that an increase in ownership interests in a subsidiary is likely to provide additional benefits to the parent. Although control has already been obtained, a higher ownership interest might increase synergies accruing to the parent, for example, by meeting legal thresholds provided in company law, which would give the parent an additional level of discretion over the subsidiary. If the additional ownership interest has been acquired in an arm's length exchange transaction in which knowledgeable, willing parties exchange equal values, these additional benefits are reflected in the purchase price of the additional ownership interest. Those Board members believe that the acquisition of non-controlling interests by the parent should give rise to the recognition of goodwill, measured as the excess of the consideration transferred over the carrying amount of the subsidiary's net assets attributable to the additional interest acquired. Those Board members acknowledge that this amount also includes unrecognised increases in the fair value of the subsidiary's net assets since the date when control was obtained. However, on the basis of cost-benefit considerations, they believe that it is a reasonable approximation of the additionally acquired goodwill.

DO6 Messrs Danjou, Gelard and Yamada agree that, in conformity with the *Framework for the Preparation and Presentation of Financial Statements*, non-controlling interests should be presented within the group's equity, because they are not liabilities. However, they believe that until the debates over the objectives of consolidated financial statements (ie what information should be provided and to whom) and the definition of the reporting entity have been settled at the conceptual level, transactions between the parent and non-controlling interests should not be accounted for in the same manner as transactions in which the parent entity acquires its own shares and reduces its equity. In their view, non-controlling interests cannot be considered equivalent to the ordinary ownership interests of the owners of the parent. The owners of the parent and the holders of non-controlling interests in a subsidiary do not share the same risks and rewards in relation to the group's operations and net assets because ownership interests in a subsidiary share only the risks and rewards associated with that subsidiary.

DO7 In addition, Messrs Danjou and Gelard observe that IFRS 3 *Business Combinations* (as revised in 2008) provides an option to measure non-controlling interests in a business combination as their proportionate share of the acquiree's net identifiable assets rather than at their fair value. However, paragraph BC207 of the Basis for Conclusions on IFRS 3 (as revised in 2008) states that accounting for the non-controlling interests at fair value is conceptually superior to this

alternative measurement. This view implies that the subsidiary's portion of goodwill attributable to the non-controlling interests at the date when control was obtained is an asset at that date and there is no conceptual reason for it no longer to be an asset at the time of any subsequent acquisitions of non-controlling interests.

DO8 Mr Garnett disagrees with the treatment of changes in controlling interests in subsidiaries after control is established (paragraphs BC41–BC52 of the Basis for Conclusions). He believes that it is important that the consequences of such changes for the owners of the parent entity are reported clearly in the financial statements.

DO9 Mr Garnett believes that the amendments to IAS 27 adopt the economic entity approach that treats all equity interests in the group as being homogeneous. Transactions between controlling and non-controlling interests are regarded as mere transfers within the total equity interest and no gain or loss is recognised on such transactions. Mr Garnett observes that the non-controlling interests represent equity claims that are restricted to particular subsidiaries, whereas the controlling interests are affected by the performance of the entire group. The consolidated financial statements should therefore report performance from the perspective of the controlling interest (a parent entity perspective) in addition to the wider perspective provided by the economic entity approach. This implies the recognition of additional goodwill on purchases, and gains or losses on disposals of the parent entity's interest in a subsidiary.

DO10 If, as Mr Garnett would prefer, the full goodwill method were not used (see paragraphs DO7–DO10 of the dissenting views on IFRS 3), the acquisition of an additional interest in a subsidiary would give rise to the recognition of additional purchased goodwill, measured as the excess of the consideration transferred over the carrying amount of the subsidiary's net assets attributable to the additional interest acquired.

DO11 Mr Garnett does not agree with the requirement in paragraph 31 of the Standard that, in respect of a partial disposal of the parent's ownership interest in a subsidiary that does not result in a loss of control, the carrying amount of the non-controlling interests should be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. On the contrary, he believes that the carrying amount of the non-controlling interests should be adjusted by the fair value of the consideration paid by the non-controlling interests to acquire that additional interest.

DO12 Mr Garnett also believes that it is important to provide the owners of the parent entity with information about the effects of a partial disposal of holdings in subsidiaries, including the difference between the fair value of the consideration received and the proportion of the carrying amount of the subsidiary's assets (including purchased goodwill) attributable to the disposal.

Loss of control

DO13 Mr Garnett disagrees with the requirement in paragraph 34 of the Standard that if a parent loses control of a subsidiary, it measures any retained investment in the former subsidiary at fair value and any difference between the carrying amount of the retained investment and its fair value is recognised in profit or loss, because the retained investment was not part of the exchange. The loss of control of a subsidiary is a significant economic event that warrants deconsolidation. However, the retained investment has not been sold. Under current IFRSs, gains and losses on cost method, available-for-sale and equity method investments are recognised in profit or loss only when the investment is sold (other than impairment). Mr Garnett would have recognised the effect of measuring the retained investment at fair value as a separate component of other comprehensive income instead of profit or loss.

Accounting for losses attributable to non-controlling interests

DO14 Mr Danjou disagrees with paragraph 28 of the Standard according to which losses can be attributed without limitation to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

DO15 In many circumstances, in the absence of any commitment or binding obligation of the non-controlling interests to make an additional investment to cover the excess losses of the subsidiary, the continuation of the operations of a subsidiary will be funded through the contribution of additional capital by the parent and with the non-controlling interests being diluted. In those circumstances, the deficit balance attributable to the non-controlling interests that would result from the amendment in paragraph 28 does not present faithfully the equity of the consolidating entity.

DO16 Mr Danjou believes that the Standard should therefore not preclude the allocation against the parent equity of losses that exceed the non-controlling interests in a consolidated subsidiary when the facts and circumstances are as outlined in paragraph DO15.

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

DO1 Professor Barth and Mr Danjou voted against the publication of *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements*). The reasons for their dissent are set out below.

DO2 These Board members disagree with the **requirement** in paragraphs 38B and 38C of IAS 27 that when a reorganisation satisfies the criteria specified in those paragraphs and the resulting new parent accounts for its investment in the original parent at cost in accordance with paragraph 38(a) of IAS 27, the new parent must measure the cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

DO3 These Board members acknowledge that a new parent could choose to apply paragraph 38(b) of IAS 27 and account for its investment in the original parent in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. However, the new parent then would be required to account for the investment in accordance with IAS 39 in subsequent periods and to account for all other investments in the same category in accordance with IAS 39.

DO4 These Board members also acknowledge, as outlined in paragraph BC66L of the Basis for Conclusions on IAS 27, that this type of reorganisation is different from other types of reorganisations in that the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation, as are the interests of the owners of the original parent in the net assets of those groups. Therefore, using the previous carrying amount to measure the cost of the new parent's investment in the original parent might be appropriate on the basis that the separate financial statements of the new parent would reflect its position as part of a pre-existing group.

DO5 However, these Board members believe that it is inappropriate to preclude a new parent from measuring the cost of its investment in the original parent at the fair value of the shares that it issues as part of the reorganisation. Separate financial statements are prepared to reflect the parent as a separate legal entity (ie not considering that the entity might be part of a group). Although such a reorganisation does not change the assets and liabilities of the group and therefore should have no accounting effect at the consolidated level, from the perspective of the new parent as a separate legal entity, its position has changed—it has issued shares and acquired an investment that it did not have previously. Also, in many jurisdictions, commercial law or corporate governance regulations require entities to measure new shares that they issue at the fair value of the consideration received for the shares.

DO6 These Board members believe that the appropriate measurement basis for the new parent's cost of its investment in the original parent depends on the Board's view of separate financial statements. The Board is or will be discussing related issues in the reporting entity phase of its Conceptual Framework project and in its project on common control transactions. Accordingly, these Board members believe that the Board should have permitted a new parent to measure the cost of its investment in the original parent either at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent or at the fair value of the equity instruments that it issues until the Board discusses the related issues in its projects on reporting entity and common control transactions.

Guidance on implementing IAS 27 *Consolidated and Separate Financial Statements* IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*

This guidance accompanies IAS 27, IAS 28 and IAS 31, but is not part of them.

Consideration of potential voting rights

Introduction

IG1 Paragraphs 14, 15 and 19 of IAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) and paragraphs 8 and 9 of IAS 28 *Investments in Associates* require an entity to consider the existence and effect of all potential voting rights that are currently exercisable or convertible. They also require all facts and circumstances that affect potential voting rights to be examined, except the intention of management and the financial ability to exercise or convert potential voting rights. Because the definition of joint control in paragraph 3 of IAS 31 *Interests in Joint Ventures* depends upon the definition of control, and because that Standard is linked to IAS 28 for application of the equity method, this guidance is also relevant to IAS 31.

Guidance

IG2 Paragraph 4 of IAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Paragraph 2 of IAS 28 defines significant influence as the power to participate in the financial and operating policy decisions of the investee but not to control those policies. Paragraph 3 of IAS 31 defines joint control as the contractually agreed sharing of control over an economic activity. In these contexts, power refers to the ability to do or effect something. Consequently, an entity has control, joint control or significant influence when it currently has the ability to exercise that power, regardless of whether control, joint control or significant influence is actively demonstrated or is passive in nature. Potential voting rights held by an entity that are currently exercisable or convertible provide this ability. The ability to exercise power does not exist when potential voting rights lack economic substance (eg the exercise price is set in a manner that precludes exercise or conversion in any feasible scenario). Consequently, potential voting rights are considered when, in substance, they provide the ability to exercise power.

IG3 Control and significant influence also arise in the circumstances described in paragraph 13 of IAS 27 and paragraphs 6 and 7 of IAS 28 respectively, which include consideration of the relative ownership of voting rights. IAS 31 depends on IAS 27 and IAS 28 and references to IAS 27 and IAS 28 from this point onwards should be read as being relevant to IAS 31. Nevertheless it should be borne in mind that joint control involves contractual sharing of control and this contractual aspect is likely to be the critical determinant. Potential voting rights such as share call options and convertible debt are capable of changing an entity's voting power over another entity—if the potential voting rights are exercised or converted, then the relative ownership of the ordinary shares carrying voting rights changes. Consequently, the existence of control (the definition of which permits only one entity to have control of another entity) and significant influence are determined only after assessing all the factors described in paragraph 13 of IAS 27 and paragraphs 6 and 7 of IAS 28 respectively, and considering the existence and effect of potential voting rights. In addition, the entity examines all facts and circumstances that affect potential voting rights except the intention of management and the financial ability to exercise or convert such rights. The intention of management does not affect the existence of power and the financial ability of an entity to exercise or convert potential voting rights is difficult to assess.

IG4 An entity may initially conclude that it controls or significantly influences another entity after considering the potential voting rights that it can currently exercise or convert. However, the entity may not control or significantly influence the other entity when potential voting rights held by other parties are also currently exercisable or convertible. Consequently, an entity considers all potential voting rights held by it and by other parties that are currently exercisable or convertible when determining whether it controls or significantly influences another entity. For example, all share call options are considered, whether held by the entity or another party. Furthermore, the definition of control in paragraph 4 of IAS 27 permits only one entity to have

control of another entity. Therefore, when two or more entities each hold significant voting rights, both actual and potential, the factors in paragraph 13 of IAS 27 are reassessed to determine which entity has control.

IG5 The proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements in accordance with IAS 27, and the proportion allocated to an investor that accounts for its investment using the equity method in accordance with IAS 28, are determined solely on the basis of present ownership interests. The proportion allocated is determined taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, give access at present to the economic benefits associated with an ownership interest.

IG6 In some circumstances an entity has, in substance, a present ownership as a result of a transaction that gives it access to the economic benefits associated with an ownership interest. In such circumstances, the proportion allocated is determined taking into account the eventual exercise of those potential voting rights and other derivatives that give the entity access to the economic benefits at present.

IG7 IAS 39 *Financial Instruments: Recognition and Measurement* does not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27, IAS 28 and IAS 31 respectively. When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of IAS 39. In all other cases, instruments containing potential voting rights are accounted for in accordance with IAS 39.

Illustrative examples

IG8 The five examples below each illustrate one aspect of a potential voting right. In applying IAS 27, IAS 28 or IAS 31, an entity considers all aspects. The existence of control, significant influence and joint control can be determined only after assessing the other factors described in IAS 27, IAS 28 and IAS 31. For the purpose of these examples, however, those other factors are presumed not to affect the determination, even though they may affect it when assessed.

Example 1: Options are out of the money

Entities A and B own 80 per cent and 20 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity C. Entity A sells one-half of its interest to Entity D and buys call options from Entity D that are exercisable at any time at a premium to the market price when issued, and if exercised would give Entity A its original 80 per cent ownership interest and voting rights.

Though the options are out of the money, they are currently exercisable and give Entity A the power to continue to set the operating and financial policies of Entity C, because Entity A could exercise its options now. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of IAS 27, are considered and it is determined that Entity A controls Entity C.

Example 2: Possibility of exercise or conversion

Entities A, B and C own 40 per cent, 30 per cent and 30 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entity A also owns call options that are exercisable at any time at the fair value of the underlying shares and if exercised would give it an additional 20 per cent of the voting rights in Entity D and reduce Entity B's and Entity C's interests to 20 per cent each. If the options are exercised, Entity A will have control over more than one-half of the voting power. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of IAS 27 and paragraphs 6 and 7 of IAS 28, are considered and it is determined that Entity A controls Entity D.

Example 3: Other rights that have the potential to increase an entity's voting power or reduce another entity's voting power

Entities A, B and C own 25 per cent, 35 per cent and 40 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entities B and C also have share warrants that are exercisable at any time at a fixed price and provide potential

voting rights. Entity A has a call option to purchase these share warrants at any time for a nominal amount. If the call option is exercised, Entity A would have the potential to increase its ownership interest, and thereby its voting rights, in Entity D to 51 per cent (and dilute Entity B's interest to 23 per cent and Entity C's interest to 26 per cent).

Although the share warrants are not owned by Entity A, they are considered in assessing control because they are currently exercisable by Entities B and C. Normally, if an action (eg purchase or exercise of another right) is required before an entity has ownership of a potential voting right, the potential voting right is not regarded as held by the entity. However, the share warrants are, in substance, held by Entity A, because the terms of the call option are designed to ensure Entity A's position. The combination of the call option and share warrants gives Entity A the power to set the operating and financial policies of Entity D, because Entity A could currently exercise the option and share warrants. The other factors described in paragraph 13 of IAS 27 and paragraphs 6 and 7 of IAS 28 are also considered, and it is determined that Entity A, not Entity B or C, controls Entity D.

Example 4: Management intention

Entities A, B and C each own 33 per cent of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entities A, B and C each have the right to appoint two directors to the board of Entity D. Entity A also owns call options that are exercisable at a fixed price at any time and if exercised would give it all the voting rights in Entity D. The management of Entity A does not intend to exercise the call options, even if Entities B and C do not vote in the same manner as Entity A. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of IAS 27 and paragraphs 6 and 7 of IAS 28, are considered and it is determined that Entity A controls Entity D. The intention of Entity A's management does not influence the assessment.

Example 5: Financial ability

Entities A and B own 55 per cent and 45 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity C. Entity B also holds debt instruments that are convertible into ordinary shares of Entity C. The debt can be converted at a substantial price, in comparison with Entity B's net assets, at any time and if converted would require Entity B to borrow additional funds to make the payment. If the debt were to be converted, Entity B would hold 70 per cent of the voting rights and Entity A's interest would reduce to 30 per cent.

Although the debt instruments are convertible at a substantial price, they are currently convertible and the conversion feature gives Entity B the power to set the operating and financial policies of Entity C. The existence of the potential voting rights, as well as the other factors described in paragraph 13 of IAS 27, are considered and it is determined that Entity B, not Entity A, controls Entity C. The financial ability of Entity B to pay the conversion price does not influence the assessment.

Appendix A
Amendments to guidance on other HKFRSs

The following amendments to guidance on other HKFRSs are necessary in order to ensure consistency with the revised HKAS 27. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

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

Appendix B
Amendments to guidance from other HKFRSs

The following amendments to guidance on other HKFRSs are necessary in order to ensure consistency with the revised HKAS 27. In the amended paragraphs, new text is underlined and deleted text is struck through. The amendments contained in this appendix when this Guidance was issued have been incorporated into the text of the relevant Guidance.

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

In the guidance on implementing IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates*, and IAS 31 *Interests in Joint Ventures*, paragraph IG7 is amended as follows:

IG7 IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* ~~does~~ do not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27, IAS 28 and IAS 31 respectively. When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of IAS 39 and IFRS 9. In all other cases, instruments containing potential voting rights are accounted for in accordance with IAS 39 and IFRS 9.

Table of Concordance

This table shows how the contents of the superseded version of HKAS 27 and the amended version of HKAS 27 (revised 2008) correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded HKAS27 paragraph	HKAS 27 (revised 2008) paragraph	Superseded HKAS 27 paragraph	HKAS 27 (revised 2008) paragraph	Superseded HKAS 27 paragraph	HKAS 27 (revised 2008) paragraph
1	1	17	None	33	27
2	2	18	None	34	28
3	3	19	16	35	28
4	4	20	17	36	29
5	5	21	32	37	38
6	6	22	18	38	39
7	7	23	19	39	40
8	8	24	20	40	41
9	9	25	21	41	42
10	10	26	22	42	43
11	11	27	23	43	44
12	12	28	24	44	46
13	13	29	25	45	None
14	14	30	26	None	30,31, 33-35, 38A-38C, 45-45C
15	15	31	36		
16	None	32	37		

The main amendments made in 2008 were:

- The term *minority interest* was replaced by the term *non-controlling interest*, with a new definition.
- An entity must attribute total comprehensive income 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. The previous version required excess losses to be allocated to the owners of the parent, except to the extent that the non-controlling interests had a binding obligation and were able to make an additional investment to cover the losses.
- Requirements were added to specify that changes in a parent's ownership interest in a subsidiary that do not result in the loss of control must be accounted for as equity transactions. The previous version did not have requirements for such transactions.
- Requirements were added to specify how an entity measures any gain or loss arising on the loss of control of a subsidiary. Any such gain or loss is recognised in profit or loss. Any investment retained in the former subsidiary is measured at its fair value at the date when control is lost. The previous version required the carrying amount of an investment retained in the former subsidiary to be regarded as its cost on initial measurement of the financial asset in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*.

The amendments also changed the structure of HKAS 27, by moving some paragraphs within the standard. The paragraphs were renumbered for ease of reading.

HKAS 28
Revised ~~May~~ July 2010

Hong Kong Accounting Standard 28

Investments in Associates

An entity shall apply amendments resulting from *Improvements to HKFRSs* issued in May 2010 for annual periods beginning on or after 1 July 2010.

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TABLE OF CONCORDANCE

Hong Kong Accounting Standard 28 *Investments in Associates* (HKAS 28) is set out in paragraphs 1-43 and Appendices B and C. All the paragraphs have equal authority. HKAS 28 should be read in the context of the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 28 *Investments in Associates* replaces SSAP 10 *Accounting for Investments in Associates* (revised in 2001) and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 28

IN2 The objectives of the Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 28 were to reduce or eliminate alternatives, redundancies and conflicts within the Standards, to deal with some convergence issues and to make other improvements.

IN3 For HKAS 28 the HKICPA's main objective was to reduce alternatives in the application of the equity method and in accounting for investments in associates in separate financial statements. The HKICPA did not reconsider the fundamental approach when accounting for investments in associates using the equity method contained in HKAS 28.

The main features

IN4 The main features of HKAS 28 are described below.

Scope

IN5 The Standards does not apply to investments that would otherwise be associates or interests of venturers in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities when those investments are classified as held for trading and accounted for in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*. Those investments are measured at fair value, with changes in fair value recognised in profit or loss in the period in which they occur.

IN6 Furthermore, the Standard provides exemptions from application of the equity method similar to those provided for certain parents not to prepare consolidated financial statements. These exemptions include when the investor is also a parent exempt in accordance with HKAS 27 *Consolidated and Separate Financial Statements* from preparing consolidated financial statements (paragraph 13(b)), and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents (paragraph 13(c)).

Significant influence

Potential voting rights

IN7 An entity is required to consider the existence and effect of potential voting rights currently exercisable or convertible when assessing whether it has the power to participate in the financial and operating policy decisions of the investee.

Equity method

IN8 The Standard clarifies that investments in associates over which the investor has significant influence must be accounted for using the equity method whether or not the investor also has investments in subsidiaries and prepares consolidated financial statements. However, the investor does not apply the equity method when presenting separate financial statements prepared in accordance with HKAS 27.

Exemption from applying the equity method

IN9 The Standard does not require the equity method to be applied when an associate is acquired and held with a view to its disposal within twelve months of acquisition. There must be evidence that the investment is acquired with the intention to dispose of it and that management is actively seeking a buyer. When such an associate is not disposed of within twelve months it must be accounted for using the equity method as from the date of acquisition, except in narrowly specified circumstances.*

IN10 The Standard does not permit an investor that continues to have significant influence over an associate not to apply the equity method when the associate is operating under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable.

Elimination of unrealised profits and losses on transactions with associates

IN11 Profits and losses resulting from 'upstream' and 'downstream' transactions between an investor and an associate must be eliminated to the extent of the investor's interest in the associate.

Non-coterminous year-ends

IN12 When financial statements of an associate used in applying the equity method are prepared as at the end of the reporting period that is different from that of the investor, the difference must be no greater than three months.

Uniform accounting policies

IN13 The Standard requires an investor to make appropriate adjustments to the associate's financial statements to conform them to the investor's accounting policies for reporting like transactions and other events in similar circumstances.

* In August 2004, the HKICPA issued HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. HKFRS 5 removes this scope exclusion and now eliminates the exemption from applying the equity method when significant influence over an associate is intended to be temporary. See HKFRS 5 Basis for Conclusions for further discussion.

Recognition of losses

IN14 An investor must consider the carrying amount of its investment in the equity of the associate and its other long-term interests in the associate when recognising its share of losses of the associate.

Separate financial statements

IN15 The requirements for the preparation of an investor's separate financial statements are established by reference to HKAS 27.

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Hong Kong Accounting Standard 28
Investments in Associates

Scope

1 **This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:**

- **(a) venture capital organisations, or**
- **(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds**

that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*. Such investments shall be measured at fair value in accordance with HKAS 39, with changes in fair value recognised in profit or loss in the period of the change. An entity holding such an investment shall make the disclosures required by paragraph 37(f).

Definitions

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

An *associate* is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Consolidated financial statements **are the financial statements of a group presented as those of a single economic entity.**

Control **is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.**

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

Joint control **is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).**

Separate financial statements **are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.**

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

A *subsidiary* **is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).**

3 Financial statements in which the equity method is applied are not separate financial statements, nor are the financial statements of an entity that does not have a subsidiary, associate or venturer's interest in a joint venture.

4 Separate financial statements are those presented in addition to consolidated financial statements, financial statements in which investments are accounted for using the equity method and financial statements in which venturers' interests in joint ventures are proportionately consolidated. Separate financial statements may or may not be appended to, or accompany, those financial statements.

5 Entities that are exempted in accordance with paragraph 10 of HKAS 27 *Consolidated and Separate Financial Statements* from consolidation, paragraph 2 of HKAS 31 *Interests in Joint Ventures* from applying proportionate consolidation or paragraph 13(c) of this Standard from applying the equity method may present separate financial statements as their only financial statements.

Significant influence

6 If an investor holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

7 The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(a) representation on the board of directors or equivalent governing body of the investee;

(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.

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8 An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

9 In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intention of management and the financial ability to exercise or convert.

10 An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

Equity method

11 Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income~~equity that have not been recognised in the investee's profit or loss~~. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised ~~directly in equity~~ in other comprehensive income of the investor (see HKAS 1 *Presentation of Financial Statements* (as revised in 2007)).

12 When potential voting rights exist, the investor's share of profit or loss of the investee and of changes in the investee's equity is determined on the basis of present ownership interests and does not reflect the possible exercise or conversion of potential voting rights.

Application of the equity method

13 An investment in an associate shall be accounted for using the equity method except when:

(a) the investment is classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;

(b) the exception in paragraph 10 of HKAS 27, allowing a parent that also has an investment in an associate not to present consolidated financial statements, applies; or

(c) all of the following apply:

(i) the investor is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;

(ii) the investor's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the counter market, including local and regional markets);

(iii) the investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market; and

(iv) the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

14 Investments described in paragraph 13(a) shall be accounted for in accordance with HKFRS 5.

15 When an investment in an associate previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using the equity method as from the date of its classification as held for sale. Financial statements for the periods since classification as held for sale shall be amended accordingly.

16 [Deleted]

17 The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relation to the performance of the associate. Because the investor has significant influence over the associate, the investor has an interest in the associate's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of profits or losses of such an associate. As a result, application of the equity method provides more informative reporting of the net assets and profit or loss of the investor.

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18[†] **An investor shall discontinue the use of the equity method from the date ~~that~~ when it ceases to have significant influence over an associate and shall account for the investment in accordance with HKAS 39 from that date, provided the associate does not become a subsidiary or a joint venture as defined in HKAS 31. On the loss of significant influence, the investor shall measure at fair value any investment the investor retains in the former associate. The investor shall recognise in profit or loss any difference between:**

(a) the fair value of any retained investment and any proceeds from disposing of the part interest in the associate; and

(b) the carrying amount of the investment at the date when significant influence is lost.

19[†] **When an investment ceases to be an associate and is accounted for in accordance with HKAS 39, ~~T~~the ~~carrying amount~~fair value of the investment at the date ~~that~~ when it ceases to be an associate shall be regarded as its ~~cost~~fair value on initial ~~measurement~~ recognition as a financial asset in accordance with HKAS 39.**

19A[†] If an investor loses significant influence over an associate, the investor shall account for all amounts recognised in other comprehensive income in relation to that associate on the same basis as would be required if the associate had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income by an associate would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses significant influence over the associate. For example, if an associate has available-for-sale financial assets and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets. If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate, the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income.

20 Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in HKAS 27. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

21 A group's share in an associate is the aggregate of the holdings in that associate by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate has subsidiaries, associates, or joint ventures, the profits or losses and net assets taken into account in applying the equity method are those recognised in the associate's financial statements (including the associate's share of the profits or losses and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 26 and 27).

† Amendments effective for annual periods beginning on or after 1 July 2009.

22 Profits and losses resulting from 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor's financial statements only to the extent of unrelated investors' interests in the associate. 'Upstream' transactions are, for example, sales of assets from an associate to the investor. 'Downstream' transactions are, for example, sales of assets from the investor to an associate. The investor's share in the associate's profits and losses resulting from these transactions is eliminated.

23[♦] An investment in an associate is accounted for using the equity method from the date on which it becomes an associate. On acquisition of the investment any difference between the cost of the investment and the investor's share of the net fair value of the associate's identifiable assets~~,~~ and liabilities ~~and contingent liabilities~~ is accounted for as follows: ~~in accordance with HKFRS 3 *Business Combinations*. Therefore:~~

(a) goodwill relating to an associate is included in the carrying amount of the investment. ~~However, a~~Amortisation of that goodwill is not permitted ~~and is therefore not included in the determination of the investor's share of the associate's profits or losses~~.

(b) any excess of the investor's share of the net fair value of the associate's identifiable assets~~,~~ and liabilities ~~and contingent liabilities~~ over the cost of the investment is ~~excluded from the carrying amount of the investment and is instead~~ included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

Appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are also made to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are made for impairment losses recognised by the associate, such as for goodwill or property, plant and equipment.

24 The most recent available financial statements of the associate are used by the investor in applying the equity method. When the ~~reporting dates~~ end of the reporting period of the investor ~~and~~ is different from that of the associate ~~are different~~, the associate prepares, for the use of the investor, financial statements as of the same date as the financial statements of the investor unless it is impracticable to do so.

25 When, in accordance with paragraph 24, the financial statements of an associate used in applying the equity method are prepared as of a different ~~reporting~~ date from that of the investor, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the investor's financial statements. In any case, the difference between the ~~reporting date~~ end of the reporting period of the associate and that of the investor shall be no more than three months. The length of the reporting periods and any difference between ~~in~~ the ~~reporting dates~~ ends of the reporting periods shall be the same from period to period.

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

26 The investor's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.

27 If an associate uses accounting policies other than those of the investor for like transactions and events in similar circumstances, adjustments shall be made to conform the associate's accounting policies to those of the investor when the associate's financial statements are used by the investor in applying the equity method.

28 If an associate has outstanding cumulative preference shares that are held by parties other than the investor and classified as equity, the investor computes its share of profits or losses after adjusting for the dividends on such shares, whether or not the dividends have been declared.

29 If an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor discontinues recognising its share of further losses. The interest in an associate is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate. Such items may include preference shares and long-term receivables or loans but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognised under the equity method in excess of the investor's investment in ordinary shares are applied to the other components of the investor's interest in an associate in the reverse order of their seniority (ie priority in liquidation).

30 After the investor's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Impairment losses

31 After application of the equity method including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of HKAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.

32 The investor also applies the requirements of HKAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.

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33 Because goodwill ~~included in~~ that forms part of the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in HKAS 36 *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested for impairment ~~under~~ in accordance with HKAS 36 as a single asset ~~for impairment~~, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in HKAS 39 indicates that the investment may be impaired. An impairment loss recognised in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate. Accordingly, any reversal of that impairment loss is recognised in accordance with HKAS 36 to the extent that the recoverable amount of the investment subsequently increases. In determining the value in use of the investment, an entity estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions, both methods give the same result.

34 The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

Separate financial statements

35[†] An investment in an associate shall be accounted for in the investor's separate financial statements in accordance with paragraphs ~~37-42~~38-43 of HKAS 27.

36 This Standard does not mandate which entities produce separate financial statements available for public use.

Disclosure

37 The following disclosures shall be made:

(a) the fair value of investments in associates for which there are published price quotations;

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

(b) summarised financial information of associates, including the aggregated amounts of assets, liabilities, revenues and profit or loss;

(c) the reasons why the presumption that an investor does not have significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting or potential voting power of the investee but concludes that it has significant influence;

(d) the reasons why the presumption that an investor has significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting or potential voting power of the investee but concludes that it does not have significant influence;

(e) the end of the reporting period ~~reporting date~~ of the financial statements of an associate, when such financial statements are used in applying the equity method and are as of a ~~reporting~~ date or for a period that is different from that of the investor, and the reason for using a different ~~reporting~~ date or different period;

(f) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of associates to transfer funds to the investor in the form of cash dividends, or repayment of loans or advances;

(g) the unrecognised share of losses of an associate, both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate;

(h) the fact that an associate is not accounted for using the equity method in accordance with paragraph 13; and

(i) summarised financial information of associates, either individually or in groups, that are not accounted for using the equity method, including the amounts of total assets, total liabilities, revenues and profit or loss.

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38 Investments in associates accounted for using the equity method shall be classified as non-current assets. The investor's share of the profit or loss of such associates, and the carrying amount of those investments, shall be separately disclosed. The investor's share of any discontinued operations of such associates shall also be separately disclosed.

39 The investor's share of changes recognised ~~directly in the associate's equity~~ in other comprehensive income by the associate shall be recognised by the investor in other comprehensive income~~directly in equity by the investor and shall be disclosed in the statement of changes in equity as required by HKAS 1~~ ~~*Presentation of Financial Statements*~~.

40 In accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the investor shall disclose:

(a) its share of the contingent liabilities of an associate incurred jointly with other investors; and

(b) those contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate.

Effective date and transition

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

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

41A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 11 and 39. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

41B[ф] HKAS 27 (as amended in 2008) amended paragraphs 18, 19 and 35 and added paragraph 19A. 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.

41C Paragraphs 1 and 33 were amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and apply for that earlier period the amendments to paragraph 3 of HKFRS 7 *Financial Instruments: Disclosures*, paragraph 1 of HKAS 31 and paragraph 4 of HKAS 32 *Financial Instruments: Presentation* issued in October 2008. An entity is permitted to apply the amendments prospectively.

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

Withdrawal of other pronouncements

42 This Standard supersedes SSAP 10 *Accounting for Investments in Associates* (revised in 2001).

43 This Standard supersedes Interpretation 18, *Consolidation and Equity Method—Potential Voting Rights and Allocation of Ownership Interests*.

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Appendix A

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 9 March 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 28.

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

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

Appendix B

Amendments to Other Pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix C

Amendments resulting from other HKFRSs

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

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

Paragraph IN5 is amended as follows:

IN5 The Standards does not apply to investments that would otherwise be associates or interests of venturers in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities when those investments are ~~classified as held for trading and~~ accounted for at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments* and HKAS 39 *Financial Instruments: Recognition and Measurement*. Those investments are measured at fair value, with changes in fair value recognised in profit or loss in the period in which they occur.

Paragraphs 1 and 18–19A are amended and paragraph 41D is added as follows:

1 This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that are measured ~~upon initial recognition are designated as~~ at fair value through profit or loss ~~or are classified as held for trading and accounted for~~ in accordance with HKFRS 9 *Financial Instruments* and HKAS 39 *Financial Instruments: Recognition and Measurement*. An entity shall measure such ~~Such~~ investments ~~shall be measured~~ at fair value through profit or loss in accordance with HKFRS 9 ~~HKAS 39, with changes in fair value recognised in profit or loss in the period of the change~~. An entity holding such an investment shall make the disclosures required by paragraph 37(f).

18 An investor shall discontinue the use of the equity method from the date when it ceases to have significant influence over an associate and shall account for the investment in accordance with HKFRS 9 and HKAS 39 from that date, provided the associate does not become a subsidiary or a joint venture as defined in HKAS 31. On the loss of significant influence, …

19 **When an investment ceases to be an associate and is accounted for in accordance with HKFRS 9 and HKAS 39, the fair value of the investment at the date when it ceases to be an associate shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9 ~~HKAS 39~~.**

19A If an investor loses significant influence over an associate, … For example, if an associate has cumulative exchange differences relating to a foreign operation ~~available-for-sale financial assets~~ and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to the foreign operation ~~those assets~~. If …

41D HKFRS 9, issued in November 2009, amended paragraphs 1 and 18–19A of this Standard as amended in May 2008. An entity shall apply those amendments if using that version of this Standard when it applies HKFRS9.

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Basis for Conclusions on HKAS 28 *Investments in Associates*

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

HKAS 28 is based on IAS 28 *Investments in Associates*. In approving HKAS 28, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 28 (as revised 2003). Accordingly, there are no significant differences between HKAS 28 and IAS 28. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 28 referred to below generally correspond with those in HKAS 28.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 28 *Accounting for Investments in Associates* 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 28. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for investments in associates established by IAS 28, this Basis for Conclusions does not discuss requirements in IAS 28 that the Board has not reconsidered.

Scope exclusion: investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities

BC4 There are no specific requirements that address accounting for investments by venture capital organisations, mutual funds, unit trusts and similar entities. As a result, depending on whether an entity has control, joint control or significant influence over an investee, one of the following Standards is applied:

(a) IAS 27 *Consolidated and Separate Financial Statements*,

(b) IAS 28 *Investments in Associates*, or

(c) IAS 31 *Interests in Joint Ventures*.

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BC5 The Board considered whether another approach is appropriate for these investors when they have joint control or significant influence over their investees. The Board noted that use of the equity or proportionate consolidation methods for investments held by venture capital organisations, mutual funds, unit trusts and similar entities often produces information that is not relevant to their management and investors and that fair value measurement produces more relevant information.

BC6 In addition, the Board noted that there may be frequent changes in the level of ownership in these investments and that financial statements are less useful if there are frequent changes in the method of accounting for an investment.

Measurement at fair value in accordance with IAS 39

BC7 Accordingly, the Board decided that investments held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds should be excluded from the scope of IAS 28 and IAS 31 when they are measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.* The Board understands that fair value information is often readily available because fair value measurement is a well-established practice in these industries including for investments in entities in the early stages of their development or in non-listed entities.

Treatment of changes in fair value

BC8 The Board decided that if venture capital organisations, mutual funds, unit trusts and similar entities are to be excluded from the scope of IAS 28, it should be only when they recognise changes in the fair value of their investments in associates in profit or loss in the period in which those changes occur. This is to achieve the same treatment as for investments in subsidiaries or associates that are not consolidated or accounted for using the equity method because control or significant influence is intended to be temporary. The Board's approach distinguishes between accounting for the investment and accounting for the economic entity. In relation to the former, the Board decided that there should be consistency in the treatment of all investments, including changes in the fair value of these investments.

BC9 The Board noted that if such investments were classified in accordance with IAS 39, they would not always meet the definition of investments held for trading because venture capital organisations may hold an investment for a period of 3-5 years. In accordance with IAS 39 such an investment is classified as available for sale (unless the entity elects to designate the investment on initial recognition at fair value through profit or loss). Classification as available for sale would not result in recognising changes in fair value in profit or loss. To achieve a similar effect on income to that of applying the equity method, the Board decided to exempt investments held by venture capital organisations, mutual funds, unit trusts and similar entities from this Standard only when they are measured at fair value through profit or loss (either by designation or because they meet the definition in IAS 39 of held for trading).

Reference to 'well-established' industry practices

BC10 The Exposure Draft proposed to limit the availability of the scope exclusion to situations in which well-established industry practice existed. Some respondents noted that the development of industry practice to measure such investments at fair value would have been precluded in industries established in countries already applying IFRSs. The Board confirmed that the main purpose of the reference to

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'well-established' practice in the Exposure Draft was to emphasise that the exclusion would apply generally to those investments for which fair value is already available.

BC11 Therefore, the Board decided that the availability of the exclusion should be based only on the nature of an entity's activities and to delete the reference to 'well-established' practices. The Board understands that measurement of these investments at fair value is 'well-established' practice in these industries.

Definition of 'venture capital organisations'

BC12 The Board decided not to define further those 'venture capital organisations and similar entities' excluded from the scope of the Standard. Apart from recognising the difficulties of arriving at a universally applicable definition, the Board did not want inadvertently to make it difficult for entities to measure investments at fair value. However, the Board decided to clarify that the reference to 'similar entities' in the scope exclusion includes investment-linked insurance funds.

BC13 The Board decided, however, that if an investee is a subsidiary in accordance with IAS 27, it should be consolidated. The Board concluded that if an investor controls an investee, the investee is part of a group and part of the structure through which the group operates its business and thus consolidation of the investee is appropriate.

Application of the equity method

Temporary significant influence

BC14 The Board considered whether to remove the exemption from applying the equity method when significant influence over an associate is intended to be temporary. The Board decided to consider this issue as part of a comprehensive standard dealing with asset disposals. It decided to retain an exemption from applying the equity method when there is evidence that an associate is acquired with the intention to dispose of it within twelve months and that management is actively seeking a buyer. The Board's Exposure Draft ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* proposes to measure and present assets held for sale in a consistent manner irrespective of whether they are held by an investor in an associate or in a subsidiary.[*]

Severe long-term restrictions impairing ability to transfer funds to the investor

BC15 The Board decided to remove the exemption from applying the equity method for an associate that previously applied when severe long-term restrictions impaired an associate's ability to transfer funds to the investor. It did so because such circumstances may not preclude the investor's significant influence over the associate. The Board decided that an investor should, when assessing its ability to exercise significant influence over an entity, consider restrictions on the transfer of funds from the associate to the investor. In themselves, such restrictions do not preclude the existence of significant influence.

[*] In March 2004, the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 removes this scope exclusion and now eliminates the exemption from applying the equity method when significant influence over an associate is intended to be temporary. See IFRS 5 Basis for Conclusions for further discussion.

Non-coterminous year-ends

BC16 The Exposure Draft of May 2002 proposed to limit to three months any difference between the reporting dates of the investor and the associate when applying the equity method. Some respondents to that Exposure Draft believed that it could be impracticable for the investor to prepare financial statements as of the same date when the date of the investor's and the associate's financial statements differ by more than three months. The Board noted that a three-month limit operates in several jurisdictions and it was concerned that a longer period, such as six months, would lead to the recognition of stale information. Therefore, it decided to retain the three-month limit.

Recognition of losses

BC17 The previous version of IAS 28 and SIC-20 *Equity Accounting Method— Recognition of Losses* restricted application of the equity method when, in accounting for the investor's share of losses, the carrying amount of the investment is reduced to zero.

BC18 The Board decided that the base to be reduced to zero should be broader than residual equity interests and should also include other non-equity interests that are in substance part of the net investment in the associate, such as long-term receivables. Therefore, the Board decided to withdraw SIC-20.

BC19 The Board also noted that if non-equity investments are not included in the base to be reduced to zero, an investor could restructure its investment to fund the majority in non-equity investments to avoid recognising the losses of the associate under the equity method.

BC20 In widening the base against which losses are to be recognised, the Board also clarified the application of the impairment provisions of IAS 39 to the financial assets that form part of the net investment.

Loss of significant influence over an associate*

BC21 In the second phase of the Board's project on business combinations, the Board observed that the loss of control of an entity and the loss of significant influence over an entity are economically similar events; thus they should be accounted for similarly. The loss of significant influence is an economic event that changes the nature of the investment. The Board concluded that the accounting guidance on the loss of control of a subsidiary should be extended to events, transactions or other changes in circumstances in which an investor loses significant influence over an investee. Thus, when an investor loses significant influence over an associate, the investor measures any retained investment at fair value. Any difference between the carrying amount of the associate when significant influence is lost, the disposal proceeds (if any) and the fair value of any retained interest is recognised in profit or loss.

* This heading and paragraph BC21 were added as a consequence of amendments to IAS 27 *Consolidated and Separate Financial Statements* made as part of the second phase of the business combinations project in 2008.

Scope (2008 amendment)*

BC22 The Board identified an apparent inconsistency in the disclosure requirements for entities that are eligible and elect to account for investments in associates at fair value in accordance with IAS 39. These investments are excluded from the scope of IAS 28 and entities are therefore not required to make the disclosures that the Standard would otherwise require. However, IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures* both require entities that account for investments in associates in accordance with IAS 39 to make the disclosures required by IAS 28 in addition to the disclosures they require.

BC23 The Board decided to remove this inconsistency by deleting from IAS 32 and IFRS 7 the general requirement to make the IAS 28 disclosures, and instead identifying the specific disclosures that should be made. The Board concluded that the specific disclosures it identified would be relevant because of the significant interest entities hold in such investments. The Board also decided to delete from IAS 32 and IFRS 7 the requirement to make the disclosures in IAS 27 because it duplicates the requirement in IAS 27.

Impairment losses (2008 amendment)*

BC24 The Board identified unclear guidance in IAS 28 regarding the extent to which an impairment reversal should be recognised as an adjustment to the carrying amount of an investment in an associate.

BC25 The Board noted that applying the equity method involves adjusting the investor's share of the impairment loss recognised by the associate on assets such as goodwill or property, plant and equipment to take account of the acquisition date fair values of those assets. The Board proposed in the exposure draft *Improvements to International Financial Reporting Standards* published in October 2007 that an additional impairment recorded by the investor, after applying the equity method, should not be allocated to any asset, including goodwill, that forms part of the carrying amount of the investment. Therefore, such an impairment charge should be reversed in a subsequent period to the extent that the recoverable amount of the investment increases.

BC26 Some respondents to the exposure draft expressed the view that the proposed amendment was not consistent with IAS 39 (regarding reversal of an impairment loss on an available-for-sale equity instrument), or with IAS 36 *Impairment of Assets*, IAS 27 and the proportionate consolidation method in IAS 31 (regarding the allocation of an impairment loss to goodwill and any reversal of an impairment loss relating to goodwill).

BC27 In its redeliberations, the Board affirmed its previous decisions but, in response to the comments made, decided to clarify the reasons for the amendments to paragraph 33. The Board decided that an investor should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate because the investment is the only asset that the investor controls and recognises.

* Paragraphs BC22–BC28 were added as a consequence of amendments to IAS 28 by *Improvements to IFRSs* issued in May 2008.

BC28 The Board also decided that any reversal of this impairment loss should be recognised as an adjustment to the investment in the associate to the extent that the recoverable amount of the investment increases. This requirement is consistent with IAS 36, which permits the reversal of impairment losses for assets other than goodwill. The Board did not propose aligning the requirements for the reversal of an impairment loss with those in IAS 39 relating to equity instruments because an entity recognises an impairment loss on an investment in an associate in accordance with IAS 36, rather than IAS 39.

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Dissenting opinion on amendment issued in May 2008

Dissent of Tatsumi Yamada

DO1 Mr Yamada voted against one of the amendments to IAS 28 *Investments in Associates* issued in *Improvements to IFRSs* in May 2008.

DO2 Mr Yamada believes it is inappropriate not to allocate any additional impairment losses to the goodwill and other assets that form part of the carrying amount of the investment in the associate. In his view, because he believes that an investor can identify attributable goodwill when it makes an investment, all impairment losses recognised with respect to the investor's investment in an associate should be allocated to the goodwill and other assets that form part of the carrying amount of the investment.

DO3 Mr Yamada also believes that all impairment losses allocated to goodwill should not be subsequently reversed. In his view the non-allocation of impairment losses to goodwill as required by the amendment and the subsequent reversal of such impairment losses in substance leads to the recognition of internally generated goodwill. He believes that the amendment to IAS 28 is not consistent with paragraphs 124 and 125 of IAS 36 *Impairment of Assets*, which prohibit the reversal of impairment losses related to goodwill.

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Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IAS 28 is amended as described below.

In paragraph BC7 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

* In November 2009 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

In paragraph BC9 the first reference to 'IAS 39' is footnoted as follows:

* In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 eliminated the available-for-sale category and permits entities to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading.

In paragraph BC22 the first reference to 'IAS 39' is footnoted as follows:

* In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

In paragraph BC26 the reference to 'IAS 39' is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

Table of Concordance

This table shows how the contents of the superseded SSAP 10 and the current HKAS 28 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

The table also shows how the requirements of Interpretation 18 have been incorporated into the current HKAS 28.

Superseded SSAP 10 paragraph	Current HKAS 28 paragraph
1	1
2	2
3	6
4	7
5	11
6	None
7	13
8	17
9	15-16
10	18-19
11	None
12	None
13	14
14	20
15	23
16	24
17	25
18	26, 27
19	28

Superseded SSAP 10 paragraph or Interpretation	Current HKAS 28 paragraph
20	29
21-23	30-32
24	None
25	33
26	34
27-32	21,22
33	40
34	None
35	None
36	38
37-40	37
41	41
Interpretation 18	8, 9, 12
None	3-5
None	10
None	19A
None	35-36
None	39
None	41a, 41A-41C
None	42, 43

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HK(IFRIC)-Int 1
~~Issued August 2004~~ Revised July 2010

HK (IFRIC) Interpretation 1

Changes in Existing Decommissioning, Restoration and Similar Liabilities

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

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HK(IFRIC) Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* (HK(IFRIC)-Int 1) is set out in paragraphs 1-10 and the Appendix. HK(IFRIC)-Int 1 is accompanied by Illustrative Examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

HK(IFRIC) INTERPRETATION 1

Changes in Existing Decommissioning, Restoration and Similar Liabilities

References*

- HKAS 1 *Presentation of Financial Statements*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 23 *Borrowing Costs*
- HKAS 36 *Impairment of Assets*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Background

1 Many entities have obligations to dismantle, remove and restore items of property, plant and equipment. In this Interpretation such obligations are referred to as 'decommissioning, restoration and similar liabilities'. Under HKAS 16, the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. HKAS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities. This Interpretation provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

Scope

2 This Interpretation applies to changes in the measurement of any existing decommissioning, restoration or similar liability that is both:

(a) recognised as part of the cost of an item of property, plant and equipment in accordance with HKAS 16; and

(b) recognised as a liability in accordance with HKAS 37.

For example, a decommissioning, restoration or similar liability may exist for decommissioning a plant, rehabilitating environmental damage in extractive industries, or removing equipment.

* With effect from 1 January 2005, all the existing Statements of Standard Accounting Practice (SSAP) and Interpretations for which there are equivalent International Accounting Standards (IAS) and SIC Interpretations will be renamed as Hong Kong Accounting Standards (HKAS) and Hong Kong (SIC) Interpretations (HK(SIC)-Int) with numbers corresponding to the equivalent IAS and SIC Interpretations, respectively. For full details of this change, please click on the following link: http://www.hkicpa.org.hk/professionaltechnical/accounting/rm/memorandum.pdf If an entity applies this Interpretation for a period beginning before 1 January 2005, the entity shall follow the requirements of SSAPs effective for that period, unless the entity is applying the relevant HKASs for that earlier period. Accordingly, references to the HKASs in this Interpretation should be read as references to the related superseded SSAPs as recorded in the table of concordance set out in the HKICPA website: http://www.hkicpa.org.hk/professionaltechnical/accounting/dueprocess/concordance.pdf, where appropriate.

Issue

3 This Interpretation addresses how the effect of the following events that change the measurement of an existing decommissioning, restoration or similar liability should be accounted for:

(a) a change in the estimated outflow of resources embodying economic benefits (eg cash flows) required to settle the obligation;

(b) a change in the current market-based discount rate as defined in paragraph 47 of HKAS 37 (this includes changes in the time value of money and the risks specific to the liability); and

(c) an increase that reflects the passage of time (also referred to as the unwinding of the discount).

Conclusions

4 Changes in the measurement of an existing decommissioning, restoration and similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, shall be accounted for in accordance with paragraphs 5-7 below.

5 If the related asset is measured using the cost model:

(a) subject to (b), changes in the liability shall be added to, or deducted from, the cost of the related asset in the current period.

(b) the amount deducted from the cost of the asset shall not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

(c) if the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the entity shall test the asset for impairment by estimating its recoverable amount, and shall account for any impairment loss, in accordance with HKAS 36.

6 If the related asset is measured using the revaluation model:

(a) changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:

(i) a decrease in the liability shall (subject to (b)) be ~~credited directly to~~ recognised in other comprehensive income and increase the revaluation surplus within equity, except that it shall be recognised in profit or loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in profit or loss;

(ii) an increase in the liability shall be recognised in profit or loss, except that it shall be ~~debited directly to~~ recognised in other comprehensive income and reduce the revaluation surplus within equity to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

(b) in the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess shall be recognised immediately in profit or loss.

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(c) a change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the ~~balance sheet date~~end of the reporting period. Any such revaluation shall be taken into account in determining the amounts to be ~~taken to profit or loss and equity~~ recognised in profit or loss or in other comprehensive income under (a). If a revaluation is necessary, all assets of that class shall be revalued.

(d) HKAS 1 requires disclosure ~~on the face of~~in the statement of ~~changes in equity~~ comprehensive income of each ~~item~~ component of other comprehensive income or expense ~~that is recognised directly in equity~~. In complying with this requirement, the change in the revaluation surplus arising from a change in the liability shall be separately identified and disclosed as such.

7 The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur. This applies under both the cost model and the revaluation model.

8 The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. ~~The allowed alternative treatment of c~~Capitalisation under HKAS 23 is not permitted[§].

Effective date

9 An entity shall apply this Interpretation for annual periods beginning on or after 1 September 2004. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 September 2004, it shall disclose that fact.

9A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 6. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

Transition

10 Changes in accounting policies shall be accounted for according to the requirements of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.[*]

~~[§] If an entity applies this Interpretation for a period beginning before 1 January 2005, the allowed alternative treatment referred to in the last sentence of this paragraph should be read as the treatment of capitalisation under the previous version of HKAS 23, which was entitled SSAP 19 *Borrowing Costs*, unless the entity is applying HKAS 23 for that earlier period.~~

[*] If an entity applies this Interpretation for a period beginning before 1 January 2005, the entity shall follow the requirements of the previous version of HKAS 8, which was entitled SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, unless the entity is applying the revised version of that Standard for that earlier period.

Appendix

Amendments to HKFRS 1 *First-time Adoption of International Financial Reporting Standards*

The amendments in this appendix shall be applied for annual periods beginning on or after 1 September 2004. If an entity applies this Interpretation for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standards.

Illustrative examples

These examples accompany, but are not part of, IFRIC 1.

Common facts

IE1 An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1 January 2000. The plant has a useful life of 40 years. Its initial cost was CU120,000*; this included an amount for decommissioning costs of CU10,000, which represented CU70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31 December.

Example 1: Cost model

IE2 On 31 December 2009, the plant is 10 years old. Accumulated depreciation is CU30,000 (CU120,000 x 10/40 years). Because of the unwinding of discount (5 per cent) over the 10 years, the decommissioning liability has grown from CU10,000 to CU16,300.

IE3 On 31 December 2009, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the decommissioning liability has decreased by CU8,000. Accordingly, the entity adjusts the decommissioning liability from CU16,300 to CU8,300. On this date, the entity makes the following journal entry to reflect the change:

	CU	CU
Dr decommissioning liability	8,000	
Cr cost of asset		8,000

IE4 Following this adjustment, the carrying amount of the asset is CU82,000 (CU120,000 – CU8,000 – CU30,000), which will be depreciated over the remaining 30 years of the asset's life giving a depreciation expense for the next year of CU2,733 (CU82,000 ÷ 30). The next year's finance cost for the unwinding of the discount will be CU415 (CU8,300 x 5 per cent).

IE5 If the change in the liability had resulted from a change in the discount rate, instead of a change in the estimated cash flows, the accounting for the change would have been the same but the next year's finance cost would have reflected the new discount rate.

Example 2: Revaluation model

IE6 The entity adopts the revaluation model in IAS 16 whereby the plant is revalued with sufficient regularity that the carrying amount does not differ materially from fair value. The entity's policy is to eliminate accumulated depreciation at the revaluation date against the gross carrying amount of the asset.

IE7 When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained. For example:

(a) if an asset is valued on a discounted cash flow basis, some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation), whereas others may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation), because an entity acquiring the asset will generally also assume the decommissioning obligation. For financial reporting purposes, the decommissioning obligation is recognised as a separate liability, and is not deducted from the asset.

* In these examples, monetary amounts are denominated in currency units (CU).

Accordingly, if the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice.*

(b) if an asset is valued on a depreciated replacement cost basis, the valuation obtained may not include an amount for the decommissioning component of the asset. If it does not, an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component.

IE8 Assume that a market-based discounted cash flow valuation of CU115,000 is obtained at 31 December 2002. It includes an allowance of CU11,600 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. The amounts included in the ~~balance sheet~~statement of financial position at 31 December 2002 are therefore:

	CU
Asset at valuation (1)	126,600
Accumulated depreciation	nil
Decommissioning liability	(11,600)
Net assets	115,000
Retained earnings (2)	(10,600)
Revaluation surplus (3)	15,600

Notes:

(1) Valuation obtained of CU115,000 plus decommissioning costs of CU11,600, allowed for in the valuation but recognised as a separate liability = CU126,600.

(2) Three years' depreciation on original cost CU120,000 x 3/40 = CU9,000 plus cumulative discount on CU10,000 at 5 per cent compound = CU1,600; total CU10,600.

(3) Revalued amount CU126,600 less previous net book value of CU111,000 (cost CU120,000 less accumulated depreciation CU9,000).

IE9 The depreciation expense for 2003 is therefore CU3,420 (CU126,600 x 1/37) and the discount expense for 2003 is CU600 (5 per cent of CU11,600). On 31 December 2003, the decommissioning liability (before any adjustment) is CU12,200 and the discount rate has not changed. However, on that date, the entity estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by CU5,000. Accordingly, the entity adjusts the decommissioning liability from CU12,200 to CU7,200.

IE10 The whole of this adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognised had the asset been carried under the cost model. If it had done, the excess would have been taken to profit or loss in accordance with paragraph 6(b). The entity makes the following journal entry to reflect the change:

	CU	CU
Dr decommissioning liability	5,000	
Cr revaluation surplus		5,000

* For examples of this principle, see IAS 36 *Impairment of Assets* and IAS 40 *Investment Property*.

IE11 The entity decides that a full valuation of the asset is needed at 31 December 2003, in order to ensure that the carrying amount does not differ materially from fair value. Suppose that the asset is now valued at CU107,000, which is net of an allowance of CU7,200 for the reduced decommissioning obligation that should be recognised as a separate liability. The valuation of the asset for financial reporting purposes, before deducting this allowance, is therefore CU114,200. The following additional journal entry is needed:

	CU	CU
Dr accumulated depreciation (1)	3,420	
Cr asset at valuation		3,420
Dr revaluation surplus (2)	8,980	
Cr asset at valuation (3)		8,980

Notes:

(1) Eliminating accumulated depreciation of CU3,420 in accordance with the entity's accounting policy.

(2) The debit is to revaluation surplus because the deficit arising on the revaluation does not exceed the credit balance existing in the revaluation surplus in respect of the asset.

(3) Previous valuation (before allowance for decommissioning costs) CU126,600, less cumulative depreciation CU3,420, less new valuation (before allowance for decommissioning costs) CU114,200.

IE12 Following this valuation, the amounts included in the ~~balance sheet~~statement of financial position are:

	CU
Asset at valuation	114,200
Accumulated depreciation	nil
Decommissioning liability	(7,200)
Net assets	107,000
Retained earnings (1)	(14,620)
Revaluation surplus (2)	11,620

Notes:

(1) CU10,600 at 31 December 2002 plus 2003's depreciation expense of CU3,420 and discount expense of CU600 = CU14,620.

(2) CU15,600 at 31 December 2002, plus CU5,000 arising on the decrease in the liability, less CU8,980 deficit on revaluation = CU11,620.

Example 3: Transition

IE13 The following example illustrates retrospective application of the Interpretation for preparers that already apply IFRSs. Retrospective application is required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, where practicable, and is the treatment in IAS 8. The example assumes that the entity:

(a) adopted IAS 37 on 1 July 1999;

(b) adopts the Interpretation on 1 January 2005; and

(c) before the adoption of the Interpretation, recognised changes in estimated cash flows to settle decommissioning liabilities as income or expense.

IE14 On 31 December 2000, because of the unwinding of the discount (5 per cent) for one year, the decommissioning liability has grown from CU10,000 to CU10,500. In addition, based on recent facts, the entity estimates that the present value of the decommissioning liability has increased by CU1,500 and accordingly adjusts it from CU10,500 to CU12,000. In accordance with its then policy, the increase in the liability is recognised in profit or loss.

IE15 On 1 January 2005, the entity makes the following journal entry to reflect the adoption of the Interpretation:

	CU	CU
Dr cost of asset	1,500	
Cr accumulated depreciation		154
Cr opening retained earnings		1,346

IE16 The cost of the asset is adjusted to what it would have been if the increase in the estimated amount of decommissioning costs at 31 December 2000 had been capitalised on that date. This additional cost would have been depreciated over 39 years. Hence, accumulated depreciation on that amount at 31 December 2004 would be CU154 (CU1,500 x 4/39 years).

IE17 Because, before adopting the Interpretation on 1 January 2005, the entity recognised changes in the decommissioning liability in profit or loss, the net adjustment of CU1,346 is recognised as a credit to opening retained earnings. This credit is not required to be disclosed in the financial statements, because of the restatement described below.

IE18 IAS 8 requires the comparative financial statements to be restated and the adjustment to opening retained earnings at the start of the comparative period to be disclosed. The equivalent journal entries at 1 January 2004 are shown below. In addition, depreciation expense for the year ended 31 December 2004 is increased by CU39 from the amount previously reported:

	CU	CU
Dr cost of asset	1,500	
Cr accumulated depreciation		115
Cr opening retained earnings		1,385

Basis for Conclusions on HK(IFRIC)-Int 1

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

The original text has been marked up to reflect the revision of IAS 1 Presentation of Financial Statements in 2007: new text is underlined and deleted text is struck through.

HK(IFRIC) Interpretation 1 is based on IFRIC Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. In approving HK(IFRIC) Interpretation 1, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on HK(IFRIC) Interpretation 1. Accordingly, there are no significant differences between HKFRS Interpretation 1 and IFRIC Interpretation 1. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 1 referred to below generally correspond with those in HK(IFRIC) Interpretation 1.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 IAS 16 *Property, Plant and Equipment* requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing an asset and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

BC3 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that the measurement of the liability, both initially and subsequently, should be the estimated expenditure required to settle the present obligation at the ~~balance sheet date~~end of the reporting period and should reflect a current market-based discount rate. It requires provisions to be reviewed at ~~each balance sheet date~~the end of each reporting period and adjusted to reflect the current best estimate. Hence, when the effect of a change in estimated outflows of resources embodying economic benefits and/or the discount rate is material, that change should be recognised.

BC4 The IFRIC was asked to address how to account for changes in decommissioning, restoration and similar liabilities. The issue is whether changes in the liability should be recognised in current period profit or loss, or added to (or deducted from) the cost of the related asset. IAS 16 contains requirements for the initial capitalisation of decommissioning costs and IAS 37 contains requirements for measuring the resulting liability; neither specifically addresses accounting for the effect of changes in the liability. The IFRIC was informed that differing views exist, resulting in a risk of divergent practices developing.

BC5 Accordingly, the IFRIC decided to develop guidance on accounting for the changes. In so doing, the IFRIC recognised that the estimation of the liability is inherently subjective, since its settlement may be very far in the future and estimating (a) the timing and amount of the outflow of resources embodying economic benefits (eg cash flows) required to settle the obligation and (b) the discount rate often involves the exercise of considerable judgement. Hence, it is likely that revisions to the initial estimate will be made.

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Scope

BC6 The scope of the Interpretation addresses the accounting for changes in estimates of existing liabilities to dismantle, remove and restore items of property, plant and equipment that fall within the scope of IAS 16 and are recognised as a provision under IAS 37. The Interpretation does not apply to changes in estimated liabilities in respect of costs that fall within the scope of other IFRSs, for example, inventory or production costs that fall within the scope of IAS 2 *Inventories*. The IFRIC noted that decommissioning obligations associated with the extraction of minerals are a cost either of the property, plant and equipment used to extract them, in which case they are within the scope of IAS 16 and the Interpretation, or of the inventory produced, which should be accounted for under IAS 2.

Basis for Consensus

BC7 The IFRIC reached a consensus that changes in an existing decommissioning, restoration or similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, should be added to or deducted from the cost of the related asset and depreciated prospectively over its useful life.

BC8 In developing its consensus, the IFRIC also considered the following three alternative approaches for accounting for changes in the outflow of resources embodying economic benefits and changes in the discount rate:

(a) capitalising only the effect of a change in the outflow of resources embodying economic benefits that relate to future periods, and recognising in current period profit or loss all of the effect of a change in the discount rate.

(b) recognising in current period profit or loss the effect of all changes in both the outflow of resources embodying economic benefits and the discount rate.

(c) treating changes in an estimated decommissioning, restoration and similar liability as revisions to the initial liability and the cost of the asset. Under this approach, amounts relating to the depreciation of the asset that would have been recognised to date would be reflected in current period profit or loss and amounts relating to future depreciation would be capitalised.

BC9 The IFRIC rejected alternative (a), because this approach does not treat changes in the outflow of resources embodying economic benefits and in the discount rate in the same way, which the IFRIC agreed is important, given that matters such as inflation can affect both the outflow of economic benefits and the discount rate.

BC10 In considering alternative (b), the IFRIC observed that recognising all of the change in the discount rate in current period profit or loss correctly treats a change in the discount rate as an event of the present period. However, the IFRIC decided against alternative (b) because recognising changes in the estimated outflow of resources embodying economic benefits in current period profit or loss would be inconsistent with the initial capitalisation of decommissioning costs under IAS 16.

BC11 Alternative (c) was the approach proposed in draft Interpretation D2 *Changes in Decommissioning, Restoration and Similar Liabilities*, published on 4 September 2003. In making that proposal, the IFRIC regarded the asset, from the time the liability for decommissioning is first incurred until the end of the asset's useful life, as the unit of account to which decommissioning costs relate. It therefore took the view that revisions to the estimates of those costs, whether through revisions to estimated outflows of resources embodying economic benefits or revisions to the discount rate, ought to be accounted for in the same manner as the initial estimated cost. The IFRIC still sees merit in this proposal, but concluded on balance that, under current

standards, full prospective capitalisation should be required for the reasons set out in paragraphs BC12-BC18.

IAS 8 and a change in accounting estimate

BC12 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to recognise a change in an accounting estimate prospectively by including it in profit or loss in the period of the change, if the change affects that period only, or the period of the change and future periods, if the change affects both. To the extent that a change in an accounting estimate gives rise to changes in assets or liabilities, or relates to an item of equity, it is required to be recognised by adjusting the asset, liability or equity item in the period of change.

BC13 Although the IFRIC took the view that the partly retrospective treatment proposed in D2 is consistent with these requirements of IAS 8, most responses to the draft Interpretation suggested that IAS 8 would usually be interpreted as requiring a fully prospective treatment. The IFRIC agreed that IAS 8 would support a fully prospective treatment also, and this is what the Interpretation requires.

IAS 16 and changes in accounting estimates for property, plant and equipment

BC14 Many responses to the draft Interpretation argued that the proposal in D2 was inconsistent with IAS 16, which requires other kinds of change in estimate for property, plant and equipment to be dealt with prospectively. For example, as IAS 8 also acknowledges, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised in profit or loss in the current period. The effect, if any, on future periods is recognised in profit or loss in those future periods.

BC15 Some responses to the draft Interpretation noted that a change in the estimate of a residual value is accounted for prospectively and does not require a catch-up adjustment. They observed that liabilities relating to decommissioning costs can be regarded as negative residual values, and suggested that the Interpretation should not introduce inconsistent treatment for similar events. Anomalies could result if two aspects of the same change are dealt with differently—for example, if the useful life of an asset was extended and the present value of the decommissioning liability reduced as a result.

BC16 The IFRIC agreed that it had not made a sufficient case for treating changes in estimates of decommissioning and similar liabilities differently from other changes in estimates for property, plant and equipment. The IFRIC understood that there was no likelihood of the treatment of other changes in estimate for such assets being revisited in the near future.

BC17 The IFRIC also noted that the anomalies that could result from its original proposal, if other changes in estimate were dealt with prospectively, were more serious than it had understood previously, and that a fully prospective treatment would be easier to apply consistently.

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BC18 The IFRIC had been concerned that a fully prospective treatment could result in either unrealistically large assets or negative assets, particularly if there are large changes in estimates toward the end of an asset's life. The IFRIC noted that the first concern could be dealt with if the assets were reviewed for impairment in accordance with IAS 36 *Impairment of Assets*, and that a zero asset floor could be applied to ensure that an asset did not become negative if cost estimates reduced significantly towards the end of its life. The credit would first be applied to write the carrying amount of the asset down to nil and then any residual credit adjustment would be recognised in profit or loss. These safeguards are included in the final consensus.

Comparison with US GAAP

BC19 In reaching its consensus, the IFRIC considered the US GAAP approach in Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143). Under that standard, changes in estimated cash flows are capitalised as part of the cost of the asset and depreciated prospectively, but the decommissioning obligation is not required to be revised to reflect the effect of a change in the current market assessed discount rate.

BC20 The treatment of changes in estimated cash flows required by this Interpretation is consistent with US GAAP, which the proposal in D2 was not. However, the IFRIC agreed that because IAS 37 requires a decommissioning obligation to reflect the effect of a change in the current market-based discount rate (see paragraph BC3), it was not possible to disregard changes in the discount rate. Furthermore, SFAS 143 did not treat changes in cash flows and discount rates in the same way, which the IFRIC had agreed was important.

The interaction of the Interpretation and initial recognition under IAS 16

BC21 In developing the Interpretation, the IFRIC considered the improvements that have been made to IAS 16 by the Board and agreed that it would explain the interaction of the two.

BC22 IAS 16 (as revised in 2003) clarifies that the initial measurement of the cost of an item of property, plant and equipment should include the cost of dismantling and removing the item and restoring the site on which it is located, if this obligation is incurred either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. This is because the Board concluded that whether the obligation is incurred upon acquisition of the item or as a consequence of using it, the underlying nature of the cost and its association with the asset are the same.

BC23 However, in considering the improvements to IAS 16, the Board did not address how an entity would account for (a) changes in the amount of the initial estimate of a recognised obligation, (b) the effects of accretion of, or changes in interest rates on, a recognised obligation or (c) the cost of obligations that did not exist when the entity acquired the item, such as an obligation triggered by a change in a law enacted after the asset is acquired. The Interpretation addresses issues (a) and (b).

The interaction of the Interpretation and the choice of measurement model under IAS 16

BC24 IAS 16 allows an entity to choose either the cost model or the revaluation model for measuring its property, plant and equipment, on a class-by-class basis. The IFRIC's view is that the measurement model that an entity chooses under IAS 16 would not be affected by the Interpretation.

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BC25 Several responses to the draft Interpretation sought clarification of how it should be applied to revalued assets. The IFRIC noted that:

(a) if the entity chooses the revaluation model, IAS 16 requires the valuation to be kept sufficiently up to date that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.[*] This Interpretation requires a change in a recognised decommissioning, restoration or similar liability generally to be added to or deducted from the cost of the asset. However, a change in the liability does not, of itself, affect the *valuation* of the asset for financial reporting purposes, because (to ensure that it is not counted twice) the separately recognised liability is excluded from its valuation.

(b) rather than changing the valuation of the asset, a change in the liability affects the difference between what would have been reported for the asset under the cost model, under this Interpretation, and its valuation. In other words, it changes the revaluation surplus or deficit that has previously been recognised for the asset. For example, if the liability increases by CU20, which under the cost model would have been added to the cost of the asset, the revaluation surplus reduces (or the revaluation deficit increases) by CU20. Under the revaluation model set out in IAS 16, cumulative revaluation surpluses for an asset are accounted for in equity,[‡] and cumulative revaluation deficits are accounted for in profit or loss. The IFRIC decided that changes in the liability relating to a revalued asset should be accounted for in the same way as other changes in revaluation surpluses and deficits under IAS 16.

(c) although a change in the liability does not directly affect the value of the asset for financial reporting purposes, many events that change the value of the liability may also affect the value of the asset, by either a greater or lesser amount. The IFRIC therefore decided that, for revalued assets, a change in a decommissioning liability indicates that a revaluation may be required. Any such revaluation should be taken into account in determining the amount taken to profit or loss under (b) above. If a revaluation is done, IAS 16 requires all assets of the same class to be revalued.

(d) the depreciated cost of an asset (less any impairment) should not be negative, regardless of the valuation model, and the revaluation surplus on an asset should not exceed its value. The IFRIC therefore decided that, if the reduction in a liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess reduction should always be taken to profit or loss. For example, if the depreciated cost of an unimpaired asset is CU25, and its revalued amount is CU100, there is a revaluation surplus of CU75. If the decommissioning liability associated with the asset is reduced by CU30, the depreciated cost of the asset should be reduced to nil, the revaluation surplus should be increased to CU100 (which equals the value of the asset), and the remaining CU5 of the reduction in the liability should be taken to profit or loss.

[*] IAS 1 *Presentation of Financial Statements* (revised 2007) replaced the term ‘balance sheet date’ with ‘end of the reporting period’.

[†] As a consequence of the revision of IAS 1 in 2007 the increase is recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

The unwinding of the discount

BC26 The IFRIC considered whether the unwinding of the discount is a borrowing cost for the purposes of IAS 23 *Borrowing Costs*. This question arises because if the unwinding of the discount rate were deemed a borrowing cost for the purposes of IAS 23, in certain circumstances this amount might be capitalised under the allowed alternative treatment of capitalisation.* The IFRIC noted that IAS 23 addresses funds borrowed specifically for the purpose of obtaining a particular asset. It agreed that a decommissioning liability does not fall within this description since it does not reflect funds (ie cash) borrowed. Hence, the IFRIC concluded that the unwinding of the discount is not a borrowing cost as defined in IAS 23.

BC27 The IFRIC agreed that the unwinding of the discount as referred to in paragraph 60 of IAS 37 should be reported in profit or loss in the period it occurs.

Disclosures

BC28 The IFRIC considered whether the Interpretation should include disclosure guidance and agreed that it was largely unnecessary because IAS 16 and IAS 37 contain relevant guidance, for example:

(a) IAS 16 explains that IAS 8 requires the disclosure of the nature and effect of changes in accounting estimates that have an effect in the current period or are expected to have a material effect in subsequent periods, and that such disclosure may arise from changes in the estimated costs of dismantling, removing or restoring items of property, plant and equipment.

(b) IAS 37 requires the disclosure of:

(i) a reconciliation of the movements in the carrying amount of the provision for the period.

(ii) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

(iii) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

(iv) an indication of the uncertainties about the amount or timing of those outflows, and where necessary the disclosure of the major assumptions made concerning future events (eg future interest rates, future changes in salaries, and future changes in prices).

BC29 However, in respect of assets measured using the revaluation model, the IFRIC noted that changes in the liability would often be taken to the revaluation surplus. These changes reflect an event of significance to users, and the IFRIC agreed that they should be given prominence by being separately disclosed and described as such in the statement of changes in equity.†

* In March 2007, IAS 23 was revised to require the previously allowed alternative treatment of capitalisation. Capitalisation of borrowing costs for a qualifying asset becomes the only accounting treatment. That revision does not affect the reasoning set out in this Basis for Conclusions.

† As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such changes are presented in the statement of comprehensive income.

Transition

BC30 The IFRIC agreed that preparers that already apply IFRSs should apply the Interpretation in the manner required by IAS 8, which is usually retrospectively. The IFRIC could not justify another application method, especially when IAS 37 requires retrospective application.

BC31 The IFRIC noted that, in order to apply the Interpretation retrospectively, it is necessary to determine both the timing and amount of any changes that would have been required by the Interpretation. However, IAS 8 specifies that:

(a) if retrospective application is not practicable for all periods presented, the new accounting policy shall be applied retrospectively from the earliest practicable date; and

(b) if it is impracticable to determine the cumulative effect of applying the new accounting policy at the start of the current period, the policy shall be applied prospectively from the earliest date practicable.

BC32 The IFRIC noted that IAS 8 defines a requirement as impracticable when an entity cannot apply it after making every reasonable effort to do so, and gives guidance on when this is so.

BC33 However, the provisions of IAS 8 on practicability do not apply to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Retrospective application of this Interpretation at the date of transition to IFRSs, which is the treatment required by IFRS 1 in the absence of any exemptions, would require first-time adopters 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 IFRIC agreed that, as an alternative to retrospective application, an entity should be permitted to include in the depreciated cost of the asset at the date of transition an amount calculated by discounting the liability at that date back to, and depreciating it from, when it was first incurred. This Interpretation amends IFRS 1 accordingly.

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HK(IFRIC)-Int 2
~~Issued February 2005~~Revised July 2010

Effective for annual periods
beginning on or after 1 January 2005

HK(IFRIC) Interpretation 2

Members' Shares in Co-operative Entities and Similar Instruments

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

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BASIS FOR CONCLUSIONS

HK(IFRIC) Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* (HK(IFRIC)-Int 2) is set out in paragraphs 1–14A and the Appendix. HK(IFRIC)-Int 2 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKAS 32 *Financial Instruments: Disclosure and Presentation*[*]
- HKAS 39 *Financial Instruments: Recognition and Measurement*

Background

1 Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'.

2 HKAS 32 establishes principles for the classification of financial instruments as financial liabilities or equity. In particular, those principles apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. The application of those principles to members' shares in co-operative entities and similar instruments is difficult. Guidance has been requested on understanding how the principles in HKAS 32 apply to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or equity.

Scope

3 This Interpretation applies to financial instruments within the scope of HKAS 32, including financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity. This Interpretation does not apply to financial instruments that will or may be settled in the entity's own equity instruments.

Issue

4 Many financial instruments, including members' shares, have characteristics of equity, including voting rights and rights to participate in dividend distributions. Some financial instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. How should those redemption terms be evaluated in determining whether the financial instruments should be classified as liabilities or equity?

Conclusions

5 The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

6 Members' shares that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 7 and 8 is present or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

7 Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

[*] HKAS 32 was amended as HKAS 32 *Financial Instruments: Presentation* for annual periods beginning on or after 1 January 2007. In June 2008 the HKICPA amended HKAS 32 by requiring instruments to be classified as equity if those instruments have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32.

8 Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.

9 An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7 or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.

10 At initial recognition, the entity shall measure its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law discounted from the first date that the amount could be required to be paid (see example 3).

11 As required by paragraph 35 of HKAS 32, distributions to holders of equity instruments are recognised directly in equity, net of any income tax benefits. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

12 The Appendix, which is an integral part of the conclusions, provides examples of the application of these conclusions.

Disclosure

13 When a change in the redemption prohibition leads to a transfer between financial liabilities and equity, the entity shall disclose separately the amount, timing and reason for the transfer.

Effective date

14 The effective date and transition requirements of this Interpretation are the same as those for HKAS 32. An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2005. If an entity applies this Interpretation for a period beginning before 1 January 2005, it shall disclose that fact. This Interpretation shall be applied retrospectively.

14A An entity shall apply the amendments in paragraphs 6, 9, A1 and A12 for annual periods beginning on or after 1 January 2009. If an entity applies *Puttable Financial Instruments and Obligations Arising on Liquidation* (Amendments to HKAS 32 and HKAS 1), issued in June 2008, for an earlier period, the amendments in paragraphs 6, 9, A1 and A12 shall be applied for that earlier period.

Appendix

Examples of application of the conclusions

This appendix is an integral part of the Interpretation.

A1 This appendix sets out seven examples of the application of the HK(IFRIC)-Int conclusions. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instrument does not have all the features or does not meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of HKAS 32.

Unconditional right to refuse redemption (paragraph 7)

Example 1

Facts

A2 The entity's charter states that redemptions are made at the sole discretion of the entity. The charter does not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board has the right to do so.

Classification

A3 The entity has the unconditional right to refuse redemption and the members' shares are equity. HKAS 32 establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph AG26 of HKAS 32 states:

> When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
>
> (b) an intention to make distributions in the future;
>
> (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
>
> (d) the amount of the issuer's reserves;
>
> (e) an issuer's expectation of a profit or loss for a period; or
>
> (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Example 2

Facts

A4 The entity's charter states that redemptions are made at the sole discretion of the entity. However, the charter further states that approval of a redemption request is automatic unless the entity is unable to make payments without violating local regulations regarding liquidity or reserves.

Classification

A5 The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in HKAS 32, result in the classification of the financial instrument as equity. Paragraph AG25 of HKAS 32 states:

> Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]

Prohibitions against redemption (paragraphs 8 and 9)

Example 3

Facts

A6 A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20X1 100,000 shares at CU10 each (CU1,000,000);

(b) 1 January 20X2 100,000 shares at CU20 each (a further CU2,000,000, so that the total for shares issued is CU3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

A7 The entity's charter states that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20X2 the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20X3 the entity amends its governing charter and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing charter is amended

A8 Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 49 of HKAS 39, which states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand …' Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

A9 On 1 January 20X1 the maximum amount payable under the redemption provisions is 20,000 shares at CU10 each and accordingly the entity classifies CU200,000 as financial liability and CU800,000 as equity. However, on 1 January 20X2 because of the new issue of shares at CU20, the maximum amount payable under the redemption provisions increases to 40,000 shares at CU20 each. The issue of additional shares at CU20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at CU20, or CU800,000. This requires recognition of an additional liability of CU600,000. In this example no gain or loss is recognised. Accordingly the entity now classifies CU800,000 as financial liabilities and CU2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20X1 and 31 December 20X2.

After the governing charter is amended

A10 Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on 1 January 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 49 of HKAS 39. It therefore transfers on 1 January 20X3 from equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity. In this example the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

A11 Local law governing the operations of co-operatives, or the terms of the entity's governing charter, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is CU1,000,000. At the ~~balance sheet date~~end of the reporting period the balance of paid-in capital is CU900,000.

Classification

A12 In this case, CU750,000 would be classified as equity and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 18(b) of HKAS 32 states in part:

> …a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. ~~This is so~~The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease~~, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer~~. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D.

A13 The redemption prohibition described in this example is different from the restrictions described in paragraphs 19 and AG25 of HKAS 32. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, ie they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (eg given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-in capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

A14 The facts of this example are as stated in example 4. In addition, at the ~~balance sheet date~~end of the reporting period, liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the ~~balance sheet date~~end of the reporting period is that the entity cannot pay more than CU50,000 to redeem the members' shares.

Classification

A15 As in example 4, the entity classifies CU750,000 as equity and CU150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 19 and AG25 of HKAS 32 apply in this case.

Example 6

Facts

A16 The entity's governing charter prohibits it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been CU12,000 and no member's shares have been redeemed.

Classification

A17 The entity classifies CU12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

A18 The entity is a co-operative bank. Local law governing the operations of co-operative banks state that at least 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the regulations to include members' share accounts) has to be in the form of members' paid-in capital. The effect of the regulation is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On 31 December 20X1 the entity has total outstanding liabilities of CU200,000, of which CU125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the entity's charter.

Classification

A19 In this example members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 19 and AG25 of HKAS 32. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, ie they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (CU125,000) if it repaid all of its other liabilities (CU75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, ie the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Basis for Conclusions

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

HK(IFRIC) Interpretation 2 is based on IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments*. In approving HK(IFRIC) Interpretation 2, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 2. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 2 and IFRIC Interpretation 2. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 2 referred to below generally correspond with those in HK(IFRIC) Interpretation 2.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 In September 2001, the Standing Interpretations Committee instituted by the former International Accounting Standards Committee (IASC) published Draft Interpretation SIC D-34 *Financial Instruments - Instruments or Rights Redeemable by the Holder.* The Draft Interpretation stated: 'The issuer of a Puttable Instrument should classify the entire instrument as a liability.'

BC3 In 2001 the International Accounting Standards Board (IASB) began operations in succession to IASC. The IASB's initial agenda included a project to make limited amendments to the financial instruments standards issued by IASC. The IASB decided to incorporate the consensus from Draft Interpretation D-34 as part of those amendments. In June 2002 the IASB published an exposure draft of amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* that incorporated the proposed consensus from Draft Interpretation D-34.

BC4 In their responses to the Exposure Draft and in their participation in public round-table discussions held in March 2003, representatives of co-operative banks raised questions about the application of the principles in IAS 32 to members' shares. This was followed by a series of meetings between IASB members and staff and representatives of the European Association of Co-operative Banks. After considering questions raised by the bank group, the IASB concluded that the principles articulated in IAS 32 should not be modified, but that there were questions about the application of those principles to co-operative entities that should be considered by the IFRIC.

BC5 In considering the application of IAS 32 to co-operative entities, the IFRIC recognised that a variety of entities operate as co-operatives and these entities have a variety of capital structures. The IFRIC decided that its proposed Interpretation should address some features that exist in a number of co-operatives. However, the IFRIC noted that its conclusions and the examples in the Interpretation are not limited to the specific characteristics of members' shares in European co-operative banks.

Basis for consensus

BC6 Paragraph 15 of IAS 32 states:

> The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the *substance of the contractual arrangement* and the definitions of a financial liability, a financial asset and an equity instrument. [Emphasis added]

BC7 In many jurisdictions, local law or regulations state that members' shares are equity of the entity. However, paragraph 17 of IAS 32 states:

> With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a~~A~~ critical feature in differentiating a financial liability from an equity instrument is *the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder)* or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party. [Emphasis added]

BC8 Paragraphs cited in the examples in the Appendix and in the paragraphs above show that, under IAS 32, the terms of the contractual agreement govern the classification of a financial instrument as a financial liability or equity. If the terms of an instrument create an unconditional obligation to transfer cash or another financial asset, circumstances that might restrict an entity's ability to make the transfer when due do not alter the classification as a financial liability. If the terms of the instrument give the entity an unconditional right to avoid delivering cash or another financial asset, the instrument is classified as equity. This is true even if other factors make it likely that the entity will continue to distribute dividends or make or other payments. In view of those principles, the IFRIC decided to focus on circumstances that would indicate that the entity has the unconditional right to avoid making payments to a member who has requested that his or her shares be redeemed.

BC9 The IFRIC identified two situations in which a co-operative entity has an unconditional right to avoid the transfer of cash or another financial asset. The IFRIC acknowledges that there may be other situations that may raise questions about the application of IAS 32 to members' shares. However, it understands that the two situations are often present in the contractual and other conditions surrounding members' shares and that interpretation of those two situations would eliminate many of the questions that may arise in practice.

BC10 The IFRIC also noted that an entity assesses whether it has an unconditional right to avoid the transfer of cash or another financial asset on the basis of local laws, regulations and its governing charter in effect at the date of classification. This is because it is local laws, regulations and the governing charter in effect at the classification date, together with the terms contained in the instrument's documentation that constitute the terms and conditions of the instrument at that date. Accordingly, an entity does not take into account expected future amendments to local law, regulation or its governing charter.

The right to refuse redemption (paragraph 7)

BC11 An entity may have the unconditional right to refuse redemption of a member's shares. If such a right exists, the entity does not have the obligation to transfer cash or another financial asset that IAS 32 identifies as a critical characteristic of a financial liability.

BC12 The IFRIC considered whether the entity's history of making redemptions should be considered in deciding whether the entity's right to refuse requests is, in fact, unconditional. The IFRIC observed that a history of making redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26 (cited in paragraph A3), a holder's expectations about dividends do not cause a preferred share to be classified as a financial liability.

Prohibitions against redemption (paragraphs 8 and 9)

BC13 An entity may be prohibited by law or its governing charter from redeeming members' shares if doing so would cause the number of members' shares, or the amount of paid-in capital from members' shares, to fall below a specified level. While each individual share might be puttable, a portion of the total shares outstanding is not.

BC14 The IFRIC concluded that conditions limiting an entity's ability to redeem members' shares must be evaluated sequentially. Unconditional prohibitions like those noted in paragraph 8 of the consensus prevent the entity from *incurring a liability* for redemption of all or some of the members' shares, regardless of whether it would otherwise be able to satisfy that financial liability. This contrasts with conditional prohibitions that prevent payments being made only if specified conditions—such as liquidity constraints—are met. Unconditional prohibitions prevent a liability from coming into existence, whereas the conditional prohibitions may only defer the payment of a liability already incurred. Following this analysis, an unconditional prohibition affects classification when an instrument subject to the prohibition is issued or when the prohibition is enacted or added to the entity's governing charter. In contrast, conditional restrictions such as those described in paragraphs 19 and AG25 of IAS 32 do not result in equity classification.

BC15 The IFRIC discussed whether the requirements in IAS 32 can be applied to the classification of members' shares as a whole subject to a partial redemption prohibition. IAS 32 refers to 'a financial instrument', 'a financial liability' and 'an equity instrument'. It does not refer to groups or portfolios of instruments. In view of this the IFRIC considered whether it could apply the requirements in IAS 32 to the classification of members' shares subject to partial redemption prohibitions. The application of IAS 32 to a prohibition against redeeming some portion of members' shares (eg 500,000 shares of an entity with 1,000,000 shares outstanding) is unclear.

BC16 The IFRIC noted that classifying a group of members' shares using the individual instrument approach could lead to misapplication of the principle of 'substance of the contract' in IAS 32. The IFRIC also noted that paragraph 23 of IAS 32 requires an entity that has entered into an agreement to purchase its own equity instruments to recognise a financial liability for the present value of the redemption amount (eg for the present value of the forward repurchase price, option exercise price or other redemption amount) even though the shares subject to the repurchase agreement are not individually identified. Accordingly, the IFRIC decided that for purposes of classification there are instances when IAS 32 does not require the individual instrument approach.

BC17 In many situations, looking at either individual instruments or all of the instruments governed by a particular contract would result in the same classification as financial liability or equity under IAS 32. Thus, if an entity is prohibited from redeeming any of its members' shares, the shares are not puttable and are equity. On the other hand, if there is no prohibition on redemption and no other conditions apply, members' shares are puttable and the shares are financial liabilities. However, in the case of partial prohibitions against redemption, the classification of members' shares governed by the same charter will differ, depending on whether such a classification is based on individual members' shares or the group of members' shares as a whole. For example, consider an entity with a partial prohibition that prevents it from redeeming 99 per cent of the highest number of members' shares ever outstanding. The classification based on individual shares considers each share to be potentially puttable and therefore a financial liability. This is different from the classification based on all of the members' shares. While each member's share may be redeemable individually, 99 per cent of the highest number of shares ever outstanding is not redeemable in any circumstances other than liquidation of the entity and therefore is equity.

Measurement on initial recognition (paragraph 10)

BC18 The IFRIC noted that when the financial liability for the redemption of members' shares that are redeemable on demand is initially recognised, the financial liability is measured at fair value in accordance with paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement.* Paragraph 49 states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid'. Accordingly, the IFRIC decided that the fair value of the financial liability for redemption of members' shares redeemable on demand is the maximum amount payable under the redemption provisions of its governing charter or applicable law. The IFRIC also considered situations in which the number of members' shares or the amount of paid-in capital subject to prohibition against redemption may change. The IFRIC concluded that a change in the level of a prohibition against redemption should lead to a transfer between financial liabilities and equity.

Subsequent measurement

BC19 Some respondents requested additional guidance on subsequent measurement of the liability for redemption of members' shares. The IFRIC noted that the focus of this Interpretation was on clarifying the classification of financial instruments rather than their subsequent measurement. Also, the IASB has on its agenda a project to address the accounting for financial instruments (including members' shares) that are redeemable at a pro rata share of the fair value of the residual interest in the entity issuing the financial instrument. The IASB will consider certain measurement issues in this project. The IFRIC was also informed that the majority of members' shares in co-operative entities are not redeemable at a pro rata share of the fair value of the residual interest in the co-operative entity thereby obviating the more complex measurement issues. In view of the above, the IFRIC decided not to provide additional guidance on measurement in the Interpretation.

Presentation

BC20 The IFRIC noted that entities whose members' shares are not equity could use the presentation formats included in paragraphs IE32 and IE33 of the Illustrative Examples with IAS 32.

Alternatives considered

BC21 The IFRIC considered suggestions that:

(a) members' shares should be classified as equity until a member has requested redemption. That member's share would then be classified as a financial liability and this treatment would be consistent with local laws. Some commentators believe this is a more straightforward approach to classification.

(b) the classification of members' shares should incorporate the probability that members will request redemption. Those who suggest this view observe that experience shows this probability to be small, usually within 1-5 per cent, for some types of co-operative. They see no basis for classifying 100 per cent of the members' shares as liabilities on the basis of the behaviour of 1 per cent.

BC22 The IFRIC did not accept those views. Under IAS 32, the classification of an instrument as financial liability or equity is based on the 'substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.' In paragraph BC7 of the Basis for Conclusions on IAS 32, the IASB observed:

> Although the legal form of such financial instruments often includes a right to the residual interest in the assets of an entity available to holders of such instruments, the inclusion of an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. The classification as a financial liability is independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity.

BC23 The IFRIC also observed that an approach similar to that in paragraph BC21(a) is advocated in the Dissenting Opinion of one Board member on IAS 32. As the IASB did not adopt that approach its adoption here would require an amendment to IAS 32.

Transition and effective date (paragraph 14)

BC24 The IFRIC considered whether its Interpretation should have the same transition and effective date as IAS 32, or whether a later effective date should apply with an exemption from IAS 32 for members' shares in the interim. Some co-operatives may wish to amend their governing charter in order to continue their existing practice under national accounting requirements of classifying members' shares as equity. Such amendments usually require a general meeting of members and holding a meeting may not be possible before the effective date of IAS 32.

BC25 After considering a number of alternatives, the IFRIC decided against any exemption from the transition requirements and effective date in IAS 32. In reaching this conclusion, the IFRIC noted that it was requested to provide guidance on the application of IAS 32 when it is first adopted by co-operative entities, ie from 1 January 2005. Also, the vast majority of those who commented on the draft Interpretation did not object to the proposed effective date of 1 January 2005. Finally, the IFRIC observed that classifying members' shares as financial liabilities before the date that the terms of these shares are amended will affect only 2005 financial statements, as first-time adopters are not required to apply IAS 32 to earlier periods. As a result, any effect of the Interpretation on first-time adopters is expected to be limited. Furthermore, the IFRIC noted that regulators are familiar with the accounting issues involved. A co-operative entity may be required to present members' shares as a liability until the governing charter is amended. The IFRIC understands that such amendments, if adopted, could be in place by mid-2005. Accordingly, the IFRIC decided that the effective date for the Interpretation would be annual periods beginning on or after 1 January 2005.

HK(IFRIC)-Int 4
~~Issued February 2005~~Revised July 2010

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 4

Determining whether an Arrangement contains a Lease

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Certified Public Accountants
香港會計師公會

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BASIS FOR CONCLUSIONS ON HK(IFRIC)-Int 4

APPENDIX

Amendments resulting from other Basis for Conclusions

HK(IFRIC) Interpretation 4 *Determining whether an Arrangement contains a Lease* (HK(IFRIC)-Int 4) is set out in paragraphs 1-17 and the Appendix. HK(IFRIC)-Int 4 is accompanied by illustrative examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

HK(IFRIC)-Int 4
Determining whether an Arrangement contains a Lease

References[ϕ]

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 17 *Leases*
- HKAS 38 *Intangible Assets*~~+~~
- HK(IFRIC) - Int 12 *Service Concession Arrangements*

Background

1 An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (eg an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:

- outsourcing arrangements (eg the outsourcing of the data processing functions of an entity).
- arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity.
- take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (eg a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).

2 This Interpretation provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with HKAS 17. It does not provide guidance for determining how such a lease should be classified under that Standard.

3 In some arrangements, the underlying asset that is the subject of the lease is a portion of a larger asset. This Interpretation does not address how to determine when a portion of a larger asset is itself the underlying asset for the purposes of applying HKAS 17. Nevertheless, arrangements in which the underlying asset would represent a unit of account in either HKAS 16 or HKAS 38 are within the scope of this Interpretation.

Scope

4 This Interpretation does not apply to arrangements that:

(a) are, or contain, leases excluded from the scope of HKAS 17; or

(b) are public-to-private service concession arrangements within the scope of HK(IFRIC)-Int 12~~ *Service Concession Arrangements*~~.

[ϕ] With effect from 1 January 2005, all the existing Statements of Standard Accounting Practice (SSAPs) and Interpretations for which there are equivalent International Accounting Standards (IAS) and SIC Interpretations will be renamed as Hong Kong Accounting Standards (HKASs) and Hong Kong (SIC) Interpretations (HK(SIC)-Int) with numbers corresponding to the equivalent IAS and SIC Interpretations, respectively. For full details of this change, please click on the following link: http://www.hkicpa.org.hk/professionaltechnical/accounting/rm/memorandum.pdf. If an entity applies this Interpretation for a period beginning before 1 January 2005, the entity shall follow the requirements of SSAPs effective for that period, unless the entity is applying the relevant HKASs for that earlier period. Accordingly, references to the HKASs in this Interpretation should be read as references to the related superseded SSAPs as recorded in the table of concordance set out in the HKICPA website: http://www.hkicpa.org.hk/professionaltechnical/accounting/dueprocess/concordance.pdf, where appropriate.

Issues

5 The issues addressed in this Interpretation are:

(a) how to determine whether an arrangement is, or contains, a lease as defined in HKAS 17;

(b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and

(c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Conclusions

Determining whether an arrangement is, or contains, a lease

6 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and

(b) the arrangement conveys a right to use the asset.

Fulfilment of the arrangement is dependent on the use of a specific asset

7 Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. For example, if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

8 An asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

Arrangement conveys a right to use the asset

9 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Assessing or reassessing whether an arrangement is, or contains, a lease

10 The assessment of whether an arrangement contains a lease shall be made at the inception of the arrangement, being the earlier of the date of the arrangement and the date of commitment by the parties to the principal terms of the arrangement, on the basis of all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any one of the following conditions is met:

(a) There is a change in the contractual terms, unless the change only renews or extends the arrangement.

(b) A renewal option is exercised or an extension is agreed to by the parties to the arrangement, unless the term of the renewal or extension had initially been included in the lease term in accordance with paragraph 4 of HKAS 17. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated under paragraphs 6-9 only with respect to the renewal or extension period.

(c) There is a change in the determination of whether fulfilment is dependent on a specified asset.

(d) There is a substantial change to the asset, for example a substantial physical change to property, plant or equipment.

11 A reassessment of an arrangement shall be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. If an arrangement is reassessed and is determined to contain a lease (or not to contain a lease), lease accounting shall be applied (or cease to apply) from:

(a) in the case of (a), (c) or (d) in paragraph 10, when the change in circumstances giving rise to the reassessment occurs;

(b) in the case of (b) in paragraph 10, the inception of the renewal or extension period.

Separating payments for the lease from other payments

12 If an arrangement contains a lease, the parties to the arrangement shall apply the requirements of HKAS 17 to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of HKAS 17. Accordingly, if an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with paragraphs 7-19 of HKAS 17. Other elements of the arrangement not within the scope of HKAS 17 shall be accounted for in accordance with other Standards.

13 For the purpose of applying the requirements of HKAS 17, payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements on the basis of their relative fair values. The minimum lease payments as defined in paragraph 4 of HKAS 17 include only payments for the lease (ie the right to use the asset) and exclude payments for other elements in the arrangement (eg for services and the cost of inputs).

14 In some cases, separating the payments for the lease from payments for other elements in the arrangement will require the purchaser to use an estimation technique. For example, a purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.

15 If a purchaser concludes that it is impracticable to separate the payments reliably, it shall:

(a) in the case of a finance lease, recognise an asset and a liability at an amount equal to the fair value of the underlying asset that was identified in paragraphs 7 and 8 as the subject of the lease. Subsequently the liability shall be reduced as payments are made and an imputed finance charge on the liability recognised using the purchaser's incremental borrowing rate of interest.*

(b) in the case of an operating lease, treat all payments under the arrangement as lease payments for the purposes of complying with the disclosure requirements of HKAS 17, but

(i) disclose those payments separately from minimum lease payments of other arrangements that do not include payments for non-lease elements, and

(ii) state that the disclosed payments also include payments for non-lease elements in the arrangement.

Effective date

16 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies this Interpretation for a period beginning before 1 January 2006, it shall disclose that fact.

16A An entity shall apply the amendment in paragraph 4(b) for annual periods beginning on or after 1 January 2008. If an entity applies HK(IFRIC)-Int 12 for an earlier period, the amendment shall be applied for that earlier period.

Transition

17. HKAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity uses this exemption, it shall apply paragraphs 6-9 of this Interpretation to arrangements existing at the start of the earliest period for which comparative information under HKFRSs is presented on the basis of facts and circumstances existing at the start of that period.

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* ie the lessee's incremental borrowing rate of interest as defined in paragraph 4 of HKAS 17.

Appendix

Amendments to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies this Interpretation for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standards.

IFRIC Interpretation 4
Illustrative Examples

These examples accompany, but are not part of, IFRIC 4.

Example of an arrangement that contains a lease

Facts

IE1 A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of gas each month.
- Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Assessment

IE2 The arrangement contains a lease within the scope of IAS 17 *Leases.* An asset (the facility) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented—in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Example of an arrangement that does not contain a lease

Facts

IE3 A manufacturing company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a specific component part of its manufactured product for a specified period of time. The supplier designs and constructs a plant adjacent to the purchaser's factory to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

- The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfil the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomic.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still pay only for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market), so it is expected that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the supplier's plant.

Assessment

IE4 The arrangement does not contain a lease within the scope of IAS 17. An asset (the plant) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomic. However, the purchaser has not obtained the right to use the plant because the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and the likelihood that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the plant is more than remote, on the basis of the facts presented. In addition, the price that the purchaser pays is fixed per unit of output taken.

Basis for Conclusions on HK(IFRIC)-Interpretation 4 *Determining whether an Arrangement contains a Lease*

This Basis for Conclusions accompanies, but is not part of, IFRIC 4.

HK(IFRIC) Interpretation 4 is based on IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease*. In approving HK(IFRIC) Interpretation 4, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 4. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 4 and IFRIC Interpretation 4. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 4 referred to below generally correspond with those in HK(IFRIC) Interpretation 4.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

BC2 The IFRIC noted that arrangements have developed in recent years that do not take the legal form of a lease but convey rights to use items for agreed periods of time in return for a payment or series of payments. Examples of such arrangements are set out in paragraph 1 of the Interpretation. The IFRIC observed that these arrangements share many features of a lease because a lease is defined in paragraph 4 of IAS 17 *Leases* as 'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments *the right to use an asset* for an agreed period of time' (emphasis added). The IFRIC noted that all arrangements meeting the definition of a lease should be accounted for in accordance with IAS 17 (subject to the scope of that Standard) regardless of whether they take the legal form of a lease. In other words, just as the Standing Interpretations Committee concluded in SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* that an arrangement that is described as a lease is not necessarily accounted for as a lease, the IFRIC concluded that an arrangement can be within the scope of IAS 17 even if it is not described as a lease. The IFRIC therefore decided that it should issue guidance to assist in determining whether an arrangement is, or contains, a lease.

BC3 The IFRIC published Draft Interpretation D3 *Determining whether an Arrangement contains a Lease* for public comment in January 2004 and received 51 comment letters in response to its proposals. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretation, IASB staff met a number of preparer constituents.

BC4 There was broad support for the IFRIC issuing an Interpretation on this topic (even among those respondents who disagreed with the criteria in D3 for determining whether a lease exists). However, some respondents to D3 questioned whether the proposals were a legitimate *interpretation* of IAS 17. In particular, some suggested that the proposals anticipated the Board's current research project on leasing.

BC5 In considering these comments, the IFRIC concluded that they primarily arose from its observation in the Basis for Conclusions on D3 that 'the lease asset under IAS 17 is the right to use [and] that this asset should not be confused with the underlying item [in the arrangement]' (eg an item of property, plant or equipment). As a result, the IFRIC understood that some respondents were concerned that D3 was requiring (or permitting) purchasers (lessees) to recognise an intangible asset for the right of use, even for leases classified as operating leases.

BC6 During redeliberation, the IFRIC affirmed its view that conceptually IAS 17 regards the asset as the right of use (although it acknowledged that in a finance lease, a lessee recognises an asset and accounts for that asset as if it were within the scope of IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*). However, the IFRIC decided to emphasise that the objective of the Interpretation is only to identify whether an arrangement contains a lease, not to change the requirements of IAS 17. Accordingly, having identified a lease, an entity accounts for that lease in accordance with IAS 17. This includes following the requirements of paragraphs 7-19 of IAS 17 to determine whether the lease should be classified as an operating

lease or as a finance lease. This means, for example, that if a purchaser satisfies the criteria in the Interpretation, it (a) recognises an asset only if substantially all the risks and rewards incidental to ownership are transferred and (b) treats the recognised asset as a leased item, rather than an intangible asset for the right to use that item.

BC7 The IFRIC reconsidered its use of the term 'item' in D3 (as in right to use an item). The IFRIC noted that it had used 'item' rather than 'asset' to refer to the underlying asset in the arrangement (eg an item of property, plant or equipment) in order to emphasise that the asset that is the subject of the Interpretation is the right of use and not the underlying item or asset. However, given that many found the use of the term confusing, the IFRIC decided in finalising the Interpretation to revert to the phrase in IAS 17 'right to use an asset'.

Multiple-element arrangements

BC8 The IFRIC observed that many of the arrangements that fall within the scope of the Interpretation are likely to involve services as well as a right to use an asset. In other words, the arrangement is what is sometimes referred to as a multiple-element arrangement. The IFRIC concluded that IAS 17 allows for separate recognition of a lease that is embedded or contained within a multiple-element arrangement because IAS 17 states (paragraph 3) that it applies to 'agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.' In addition, the definition of minimum lease payments in paragraph 4 of IAS 17 clarifies that such payments exclude costs for services. The Interpretation therefore addresses whether a multiple-element arrangement contains a lease and not just whether an *entire* arrangement is a lease.

Portions of an asset (paragraph 3)

BC9 The Interpretation (like D3) does not address what constitutes the underlying asset in the arrangement. In other words, it does not address when a portion of a larger asset can be the subject of a lease.

BC10 Some respondents to D3 suggested that this omission pointed to a flaw in the proposals. They were troubled by the potential inconsistency between the accounting for a take-or-pay arrangement for substantially all of the output from a specific asset (which could have contained a lease) and one for a smaller portion of the output (which would not have been required to be treated as containing a lease). Other respondents argued that D3 would have allowed undue flexibility and that the IFRIC should either explicitly rule out portions or provide additional guidance to clarify which portions should be recognised (for example, those that are physically distinguishable).

BC11 From an early stage in this project, the IFRIC decided that it should not address the issue of portions and should focus on the main question, ie what constitutes a lease. The IFRIC noted that the subject of portions was important in itself and had much wider applicability than the Interpretation. The IFRIC affirmed this view during its redeliberations and therefore rejected the suggestion that it also should address portions in the Interpretation. The IFRIC also concluded that it would be inappropriate to specify that the Interpretation should not be applied to an arrangement that contains a right to use a portion of an asset (whether that portion be a physically distinguishable portion of an asset, or defined by reference to the output of the asset or the time the asset is made available) because this would conflict with IAS 17. The IFRIC agreed that the phrase 'right to use an asset' does not preclude the asset being a portion of a larger asset.

BC12 However, in the light of comments from respondents, the IFRIC decided to clarify that the Interpretation should be applied to arrangements in which the underlying asset would represent the unit of account in either IAS 16 or IAS 38.

Scope (paragraph 4)

BC13 The objective of the Interpretation is to determine whether an arrangement contains a lease that falls within the scope of IAS 17. The lease is then accounted for in accordance with that Standard. Because the Interpretation should not be read as overriding any of the requirements of IAS 17, the IFRIC decided that it should clarify that if an arrangement is found to be, or contains, a lease or licensing agreement that is excluded from the scope of IAS 17, an entity need not apply IAS 17 to that lease or licensing agreement.

BC14 The IFRIC considered whether the scope of the Interpretation might overlap with IAS 39 *Financial Instruments: Recognition and Measurement.* In particular it noted the view that an arrangement for output might meet the definition of a derivative under IAS 39 but also be determined to contain a lease under this Interpretation. The IFRIC concluded that there should not be an overlap because an arrangement for output that is a derivative would not meet the criteria in paragraphs 6-9 of the Interpretation. In particular, the IFRIC noted that such an arrangement would be for a product with a quoted market price available in an active market and would therefore be unlikely to depend upon the use of a specifically identified asset.

BC14A The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 12, which was developed from draft Interpretations D12-D14. In particular it noted the views expressed by some respondents to the proposals that the contractual terms of some public-to-private service concession arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion of D12-D14. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. The IFRIC therefore amended IFRIC 4 to specify that if a public-to-private service concession arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

Consensus (paragraphs 6-15)

Criteria for determining whether an arrangement contains a lease (paragraphs 6-9)

BC15 In D3 the IFRIC proposed that three criteria would all need to be satisfied for an arrangement to be, or contain, a lease:

(a) The arrangement depends upon a specific item or items (the item). The item need not be explicitly identified by the contractual provisions of the arrangement. Rather it may be implicitly identified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative items.

(b) The arrangement conveys a right to use the item for a specific period of time such that the purchaser is able to exclude others from using the item.

(c) Payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item.

BC16 D3 also proposed that arrangements in which there is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output produced by an item would meet the second of the criteria above.

BC17 In its Basis for Conclusions on D3, the IFRIC drew attention to the similarities between its Interpretation and Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease* published by the US Emerging Issues Task Force (EITF) in May 2003. The IFRIC concluded that '[a]lthough the wording of Issue 01-8 and the draft Interpretation differ, …a similar assessment of whether an arrangement contains a lease is likely under both interpretations.'

BC18 Some respondents disagreed with the IFRIC's conclusion and suggested that the differences between the two interpretations were, in fact, significant. The IFRIC, however, maintained its original conclusion. In particular, it noted that both it and the EITF had concluded that a right of use can be conveyed in arrangements in which purchasers have rights to acquire the output that will be produced by an asset, regardless of any right or ability physically to operate or control access to that asset. Accordingly, many take-or-pay (and similar contracts) would have been similarly assessed under the two interpretations.

BC19 Nonetheless, the IFRIC agreed that some arrangements would be regarded as leases under Issue 01-8 but not under D3. The IFRIC concluded that there were two main reasons for this. First, the effect of the third criterion in D3 ('payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item') was that a purchaser would always be required to assume some pricing risk in an arrangement for there to be a lease. This is not the case under Issue 01-8. Secondly, the second criterion in D3 ('the arrangement conveys a right to use the item …such that the purchaser is able to exclude others from using the item') suggested that a right of use is conveyed in an arrangement for the output from an asset only when the purchaser is taking *substantially all* of the output from a specific asset. Under Issue 01-8, a right of use is also conveyed if the purchaser controls or operates the underlying specific asset while taking more than a *minor amount* of the output from an asset.

BC20 The IFRIC noted that the definition of a lease in IAS 17 is similar to its definition in the US standard SFAS 13 *Accounting for Leases*. Given this, the IFRIC concluded that there was no compelling reason for different assessments of whether an arrangement contains a lease under IFRSs and US GAAP. Furthermore, the IFRIC was sympathetic to the practical difficulties highlighted by some respondents that would arise in cases when an agreement would need to be assessed against two similar, but different, sets of criteria. Therefore, the IFRIC decided that it should seek to eliminate the differences between the approach in D3 and Issue 01-8 for determining whether an arrangement contains a lease. The IFRIC concluded that the most effective way of achieving this objective would be to modify its criteria to conform them more fully to the approach in Issue 01-8.

BC21 The IFRIC decided that as far as possible it should adopt the actual words from Issue 01-8, subject to differences between IAS 17 and SFAS 13. It concluded that differences in wording would not promote convergence and would be likely to cause confusion. Therefore, paragraphs 7-9 are virtually identical to Issue 01-8, except that:

(a) the Interpretation uses the term 'asset' rather than 'property, plant or equipment' as in Issue 01-8. The IFRIC noted that IAS 17 covers a broader range of leases than SFAS 13 and that there was no reason for restricting this Interpretation only to items of property, plant or equipment.

(b) the phrase 'more than a minor amount of the output' in Issue 01-8 has been expressed as 'more than an insignificant amount of the output'. This is because the latter is the more customary form of words under IFRSs and is therefore consistent with other Standards. In this context, however, the IFRIC intends 'minor' and 'insignificant' to have the same meaning.

BC22 Apart from small modifications to the wording of the first criterion in D3, the effect of converging fully with the criteria in Issue 01-8 for determining whether an arrangement contains a lease is that the second and third criteria in D3 are replaced by one criterion, requiring the arrangement to convey to the purchaser the right to control the use of the underlying asset.

BC23 Although the requirements for determining whether an arrangement contains a lease are the same under IFRSs and US GAAP, the IFRIC emphasises that any lease identified by the Interpretation may be accounted for differently under IFRSs and US GAAP because of differences between their respective leasing standards.

Fulfilment of the arrangement is dependent on the use of a specific asset (paragraphs 7 and 8)

BC24 The IFRIC agreed that a specific asset needs to be identified in the arrangement for there to be a lease. The IFRIC concluded that this follows from the definition of a lease, which refers to a 'right to use *an* asset' (emphasis added). The IFRIC also observed that dependence on a specifically identified asset is a feature that distinguishes a lease from other arrangements that also convey rights to use assets but are not leases (eg some service arrangements).

BC25 However, the IFRIC concluded that the identification of the asset in the arrangement need not be explicit. Rather, the facts and circumstances could implicitly identify an asset because it would not be economically feasible or practical for the supplier to perform its obligation by providing the use of alternative assets. Examples of when an asset may be implicitly identified are when the supplier owns only one suitable asset; the asset used to fulfil the contract needs to be at a particular location or specialised to the purchaser's needs; and the supplier is a special purpose entity formed for a limited purpose.

BC26 Some respondents to D3 noted that the effect of this first criterion is that the *purchaser's* accounting could depend on how the *supplier* chooses to fulfil the arrangement. They noted that the purchaser might have no control over this because (in form) the purchaser has contracted for output. Some respondents were also troubled by the lack of comparability, because similar arrangements for the output of an asset could be accounted for differently according to whether they depend on the use of a specific asset.

BC27 In response to the first of these comments, the IFRIC noted that how an entity chooses to obtain a product normally determines the accounting treatment; for example, an entity requiring power may choose to lease a power plant or connect to the grid and the two options would result in different accounting. Although in the respondents' example the choice is the supplier's (rather than the purchaser's), the IFRIC concluded that the critical matter is the end position of the entity (ie is there a lease?) not how it got to that position (ie whether it chose that outcome or it was imposed).

BC28 In response to the second comment, the IFRIC observed that it is important to consider the combined effect of the criteria in the Interpretation rather than considering the criteria individually. On reconsidering the proposals in D3 and the requirements of Issue 01-8, the IFRIC concluded that in the context of current IFRSs, in which executory contracts are generally not accounted for, the Interpretation identifies contracts (or an element therein) that for a purchaser warrant recognition (if the definition of a finance lease is satisfied). The IFRIC concluded that identifying and accounting for the lease element would represent an improvement to existing accounting practice.

Arrangement conveys a right to use the asset (paragraph 9)

BC29 Following Issue 01-8, the Interpretation specifies that a right of use can be conveyed if any of three criteria is satisfied.

BC30 The first two criteria consider the purchaser's ability to control physically the use of the underlying asset, either through operations or access, while obtaining or controlling more than an insignificant amount of the output of the asset. For example, a purchaser's ability to operate the asset may be evidenced by its ability to hire, fire or replace the operator of the asset or its ability to specify significant operating policies and procedures in the arrangement (as opposed to a right to monitor the supplier's activities) with the supplier having no ability to change such policies and procedures.

BC31 In D3 the IFRIC explained that it did not regard the ability of a purchaser to operate physically the underlying asset as determinative of whether a right of use has been conveyed. The IFRIC noted that asset managers 'operate' assets, but this does not necessarily convey a right of use. However, the IFRIC noted that under Issue 01-8, in addition to the ability to operate the asset, the purchaser has to be taking more than a minor amount of the output. The IFRIC agreed that in such cases the arrangement would convey a right of use.

BC32 The IFRIC agreed with the EITF that a right of use has been conveyed in arrangements in which the purchaser has the ability to control physically the use of the underlying asset through access (while obtaining or controlling more than a minor amount of the output of the asset). The IFRIC noted that in such arrangements the purchaser would have the ability to restrict the access of others to economic benefits of the underlying asset.

BC33 The third criterion for determining whether a right of use has been conveyed considers whether the purchaser is taking all or substantially all of the output or other utility of the underlying asset.

BC34 As noted above, D3 similarly specified that a right of use could be conveyed in arrangements in which there is only a remote possibility that other parties could take more than an insignificant amount of the output of an asset. Among the respondents who disagreed with the proposals in D3, it was this criterion that was considered most troublesome. They disagreed that, in certain specified circumstances, a purchaser's right to acquire the output from an asset could be equated with a right of use that asset. Among the arguments put to the IFRIC were:

(a) A right of use requires the purchaser to have the ability to control the way in which the underlying asset is used during the term of the arrangement: for example, the right for the purchaser's employees to assist or supervise the operation of the asset.

(b) In addition to the right to the output, the purchaser needs to have control over the delivery profile of the output; in other words it also needs the ability to determine when the output flows, otherwise it is simply consuming the output of the underlying asset rather than using the asset in its business.

(c) In most supply arrangements, the purchaser would not have access to the plant in the event of default by the supplier but would receive damages. The absence of this right points to there not being a lease. If the arrangement did contain a lease, the purchaser would have the ability to receive the output from the plant in the arrangement by replacing the original supplier with another service provider.

(d) D3 dismisses 'risks and rewards incidental to ownership' of the asset in determining whether an arrangement contains a lease. Therefore, arrangements in which the supplier retains significantly all of the risks and rewards of operation and ownership of the asset could be deemed to contain leases. However, in such arrangements the supplier's cash flows may have significantly more potential for variability than a 'true' lessor and the supplier may demand a return significantly above the market rate for a lessor.

BC35 In its redeliberations, the IFRIC reaffirmed its view that a purchaser that is taking substantially all of the output from an asset has the ability to restrict the access of others to the output from that asset. The purchaser therefore has a right of use because it controls access to the economic benefits to be derived from the asset. The IFRIC therefore did not agree that the absence of the ability to control physically the way in which the underlying asset is used precludes the existence of a right of use (although, as noted above, such an ability may indicate that a right of use has been conveyed).

BC36 With respect to the other points, the IFRIC noted the following:

(a) A purchaser that is taking substantially all of the output from an asset in cases when it is remote that others will be taking more than an insignificant amount of the output does in effect determine when the output flows.

(b) In most straightforward leases, any lessee that terminates the lease because of default by the lessor would no longer have access to the asset. Furthermore, in many leases that contain both a right of use and a service element, the related service contract does not operate independently (eg the lessee cannot terminate the service element alone). Indeed, the IFRIC noted that the purchaser's entitlement to damages in the event of default by the supplier indicates that a right of use was originally conveyed, and that the supplier is compensating the purchaser for withdrawing that right.

(c) Risks and rewards are in general relevant for determining lease classification rather than whether an arrangement is a lease. The IFRIC noted that in many straightforward short-term operating leases, substantially all the risks and rewards are retained by the lessor. Even if it were desirable to specify that a certain level of risks and rewards needed to be transferred for there to be a lease, the IFRIC was doubtful that such a criterion could be made operable. Nonetheless, an arrangement that conveys the right to use an asset will also convey certain risks and rewards incidental to ownership. Therefore, the transfer of risks and rewards of ownership may indicate that the arrangement conveys the right to use an asset. For example, if an arrangement's pricing provides for a fixed capacity charge designed to recover the supplier's capital investment in the underlying asset, the pricing may be persuasive evidence that it is remote that parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset, and the criterion in paragraph 9(c) is satisfied.

BC37 In adopting the approach from Issue 01-8, the IFRIC has specified that an arrangement for all or substantially all of the output from a specific asset does not convey the right to use the asset if the price that the purchaser will pay is contractually fixed per unit of output or equal to the current market price per unit of output as of the time of delivery of the output. This is because in such cases the purchaser is paying for a product or service rather than paying for the right to use the asset. In D3, the IFRIC proposed making a similar distinction by the combination of the second and third criteria (see paragraph BC15(b) and (c) above).

BC38 The IFRIC noted that its Interpretation could result in take-or-pay arrangements, in which purchasers are committed to purchase substantially all of the output from specific assets, being determined to contain leases. This is because in such arrangements the purchaser makes payments for the time that the underlying asset is made available for use rather than on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor equal to the current market price per unit of output). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier regardless of whether the purchaser uses the underlying asset or obtains the output from that asset. Payments are therefore made for the right to use that asset. The IFRIC agreed that the overall effect of such a take-or-pay arrangement is similar to that of a lease plus contracts for related services and supplies (such as contracts for the operation of the asset and the purchase of inputs).

BC39 The IFRIC observed that if an arrangement contains a lease, and the lease is an operating lease, applying the Interpretation is likely to result in the same assets, liabilities and expenses being recognised as if no lease had been identified. However, the IFRIC noted that IAS 17 requires lessors and lessees to recognise operating lease payments on a straight-line basis over the lease term (unless another systematic basis is more representative of the time pattern of the benefit derived from the leased asset), and thus adjustments to the recognition profile of the payments for the lease element might be required in some instances. Also, the IFRIC noted that the Interpretation would often result in additional disclosure, because IAS 17 requires the lessor and lessee to disclose the future minimum lease payments. The IFRIC observed that, for a purchaser, the arrangements discussed in the Interpretation typically represent significant future commitments, and yet these commitments are not specifically required to be disclosed in the financial statements by Standards other than IAS 17. The IFRIC concluded that bringing such arrangements within the scope of IAS 17 would provide users of financial statements with relevant information that is useful for assessing the purchaser's solvency, liquidity and adaptability. The IFRIC acknowledged that the disclosed information might relate only to the lease element of the arrangement; however, it agreed that it would be beyond the scope of this Interpretation to address disclosure of executory contracts more generally.

Assessing or reassessing whether an arrangement contains a lease (paragraphs 10 and 11)

BC40 In D3 the IFRIC proposed that the assessment of whether an arrangement contains a lease should be made at the inception of the arrangement on the basis of the facts and circumstances existing at that time and that, consistently with IAS 17, an arrangement should be reassessed only if there was a change in the terms of the arrangement. Hence, under D3, a supplier that subsequently obtained additional assets with which it could fulfil the arrangement, would not have reassessed the arrangement.

BC41 Some respondents disagreed with this conclusion and argued that the analogy with the requirements for reclassifying a lease in IAS 17 was not relevant because the objective of the Interpretation is to determine whether an arrangement is within the scope of IAS 17. They noted that since this depends on factors such as whether the arrangement depends on a specific asset, it was logical that reassessment should be required if those factors change.

BC42 The IFRIC was persuaded by this argument and concluded that it outweighed the concerns that it had expressed in D3 about it being unduly burdensome to require purchasers to reassess arrangements. The IFRIC also noted that its proposal in D3 was different from Issue 01-8. Given that it had modified its approach to determining whether a lease exists to converge with Issue 01-8, the IFRIC decided that it should also specify the same treatment as Issue 01-8 for reassessments.

BC43 The IFRIC noted that the requirements in paragraphs 10 and 11 relate only to determining when the arrangement should be reassessed and that they do not alter the requirements of IAS 17. Hence if an arrangement that contains a lease is required to be reassessed and found still to contain a lease, the lease is reclassified as a finance lease or operating lease only if so required by paragraph 13 of IAS 17.

Separating payments for the lease from other payments (paragraphs 12-15)

BC44 D3 proposed, and the Interpretation requires, payments in an arrangement containing both a lease and other elements (eg services) to be separated into those for the lease and those for other elements on the basis of their relative fair values. The IFRIC concluded that fair value is the most relevant and faithful representation of the underlying economics of the transaction.

BC45 The IFRIC noted that this requirement could be more onerous for purchasers than for suppliers, particularly when a purchaser has no access to the supplier's pricing information. The IFRIC therefore agreed that it should provide some guidance to assist purchasers in separating the lease from other elements in the arrangement. Nonetheless, the IFRIC acknowledged that in rare cases it might be impracticable for the purchaser to separate the payments reliably. The IFRIC noted that if this was the case and the lease was a finance lease, then the requirements of IAS 17 would ensure that the purchaser would not capitalise an amount greater than the fair value of the asset (since paragraph 20 of IAS 17 requires a lessee to recognise a finance lease asset at the fair value of the leased property or, if lower, the present value of the minimum lease payments). Accordingly, the IFRIC decided to specify that in such cases the purchaser should recognise the fair value of the underlying asset as the leased asset. If the lease is an operating lease and it is impracticable to separate the payments reliably, the IFRIC agreed, as a practical accommodation, that the purchaser should disclose all the payments under the arrangement when disclosing the minimum lease payments, and state that these also include payment for other elements in the arrangement.

BC46 Some respondents to D3 noted that if a purchaser with an operating lease does not separate the payments, the usefulness of the disclosures required by IAS 17 would be reduced. The IFRIC agreed that the minimum lease payments are often used by users of financial statements to estimate the value of assets held under operating leases and therefore concluded that lease payments that also include payments for other elements should be disclosed separately.

Transition (paragraph 17)

BC47 D3 proposed, and the Interpretation requires, retrospective application. Some respondents proposed that the Interpretation should be applied only to new arrangements starting after its effective date. Two main arguments were put forward in support of this view:

(a) convergence with Issue 01-8 (which applies to arrangements starting or modified after the beginning of an entity's next reporting period beginning after 28 May 2003); and

(b) to ease transition, particularly in the case of longer arrangements that started some years ago and where it might be difficult to make the assessments required by D3 retrospectively.

BC48 The IFRIC noted that EITF Abstracts are usually applied prospectively. In contrast, IFRSs (including Interpretations) are applied retrospectively following the principle articulated in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* The IFRIC could see no compelling argument ~~from~~ for departing from this principle. The IFRIC also noted that unless it were to specify exactly the same effective date as Issue 01-8 (which was before D3 was published), reconciling items with US GAAP would still arise.

BC49 In addition, the IFRIC decided that the continuation of some arrangements for many years emphasised the need for retrospective application. Without retrospective application, an entity could be accounting for similar arrangements differently for many years with a consequent loss of comparability.

BC50 However, the IFRIC was sympathetic to the practical difficulties raised by full retrospective application, in particular the difficulty of going back potentially many years and determining whether the criteria would have been satisfied at that time. Although IAS 8 provides relief from fully retrospective application in cases where such treatment would be impracticable, the IFRIC decided that it should provide transitional relief for existing preparers of IFRSs in the Interpretation itself. The IFRIC emphasises that this relief does not alter the transition requirements of IAS 17 and therefore if an arrangement is determined to contain a lease an entity applies IAS 17 from the inception of the arrangement.

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IFRIC 4 is amended as described below.

In paragraph BC14 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

* In November 2009 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

HK(IFRIC)-Int 5
~~Issued February 2005~~Revised July 2010

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 5

Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

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HK(IFRIC) INTERPRETATION 5

RIGHTS TO INTERESTS ARISING FROM DECOMMISSIONING,RESTORATION AND ENVIRONMENTAL REHABILITATION FUNDS

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Amendment to HKAS 39 ***Financial Instruments: Recognition and Measurement***

BASIS FOR CONCLUSIONS

APPENDIX

Amendments resulting from other Basis for Conclusions

HK(IFRIC) Interpretation 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* (HK(IFRIC)-Int 5) is set out in paragraphs 1-15 and the Appendix. HK(IFRC)-Int 5 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 5
Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

References[ϕ]

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 27 *Consolidated and Separate Financial Statements*
- HKAS 28 *Investments in Associates*
- HKAS 31 *Interests in Joint Ventures*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- HKAS 39 *Financial Instruments: Recognition and Measurement*
- HK(SIC) - Int 12 *Consolidation – Special Purpose Entities*

Background

1 The purpose of decommissioning, restoration and environmental rehabilitation funds, hereafter referred to as 'decommissioning funds' or 'funds', is to segregate assets to fund some or all of the costs of decommissioning plant (such as a nuclear plant) or certain equipment (such as cars), or in undertaking environmental rehabilitation (such as rectifying pollution of water or restoring mined land), together referred to as 'decommissioning'.

2 Contributions to these funds may be voluntary or required by regulation or law. The funds may have one of the following structures:

(a) funds that are established by a single contributor to fund its own decommissioning obligations, whether for a particular site, or for a number of geographically dispersed sites.

(b) funds that are established with multiple contributors to fund their individual or joint decommissioning obligations, when contributors are entitled to reimbursement for decommissioning expenses to the extent of their contributions plus any actual earnings on those contributions less their share of the costs of administering the fund. Contributors may have an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor.

(c) funds that are established with multiple contributors to fund their individual or joint decommissioning obligations when the required level of contributions is based on the current activity of a contributor and the benefit obtained by that contributor is based on its past activity. In such cases there is a potential mismatch in the amount of contributions made by a contributor (based on current activity) and the value realisable from the fund (based on past activity).

[ϕ] With effect from 1 January 2005, all the existing Statements of Standard Accounting Practice (SSAPs) and Interpretations for which there are equivalent International Accounting Standards (IAS) and SIC Interpretations will be renamed as Hong Kong Accounting Standards (HKASs) and Hong Kong (SIC) Interpretations (HKAS(SIC)-Int) with numbers corresponding to the equivalent IAS and SIC Interpretations, respectively. For full details of this change, please click on the following link: http://www.hkicpa.org.hk/professionaltechnical/accounting/rm/memorandum.pdf. If an entity applies this Interpretation for a period beginning before 1 January 2005, the entity shall follow the requirements of SSAPs effective for that period, unless the entity is applying the relevant HKASs for that earlier period. Accordingly, references to the HKASs or HKAS-Int in this Interpretation should be read as references to the related superseded SSAPs as recorded in the table of concordance set out in the HKICPA website: http://www.hkicpa.org.hk/professionaltechnical/accounting/dueprocess/concordance.pdf, where appropriate.

3 Such funds generally have the following features:

(a) the fund is separately administered by independent trustees.

(b) entities (contributors) make contributions to the fund, which are invested in a range of assets that may include both debt and equity investments, and are available to help pay the contributors' decommissioning costs. The trustees determine how contributions are invested, within the constraints set by the fund's governing documents and any applicable legislation or other regulations.

(c) the contributors retain the obligation to pay decommissioning costs. However, contributors are able to obtain reimbursement of decommissioning costs from the fund up to the lower of the decommissioning costs incurred and the contributor's share of assets of the fund.

(d) the contributors may have restricted access or no access to any surplus of assets of the fund over those used to meet eligible decommissioning costs.

Scope

4 This Interpretation applies to accounting in the financial statements of a contributor for interests arising from decommissioning funds that have both of the following features:

(a) the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity); and

(b) a contributor's right to access the assets is restricted.

5 A residual interest in a fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of HKAS 39 and is not within the scope of this Interpretation.

Issues

6 The issues addressed in this Interpretation are:

(a) how should a contributor account for its interest in a fund?

(b) when a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor, how should that obligation be accounted for?

Conclusions

Accounting for an interest in a fund

7 The contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay.

8 The contributor shall determine whether it has control, joint control or significant influence over the fund by reference to HKAS 27, HKAS 28, HKAS 31 and HK(SIC)-Int 12. If it does, the contributor shall account for its interest in the fund in accordance with those Standards.

9 If a contributor does not have control, joint control or significant influence over the fund, the contributor shall recognise the right to receive reimbursement from the fund as a reimbursement in accordance with HKAS 37. This reimbursement shall be measured at the lower of:

(a) the amount of the decommissioning obligation recognised; and

(b) the contributor's share of the fair value of the net assets of the fund attributable to contributors.

Changes in the carrying value of the right to receive reimbursement other than contributions to and payments from the fund shall be recognised in profit or loss in the period in which these changes occur.

Accounting for obligations to make additional contributions

10 When a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, this obligation is a contingent liability that is within the scope of HKAS 37. The contributor shall recognise a liability only if it is probable that additional contributions will be made.

Disclosure

11 A contributor shall disclose the nature of its interest in a fund and any restrictions on access to the assets in the fund.

12 When a contributor has an obligation to make potential additional contributions that is not recognised as a liability (see paragraph 10), it shall make the disclosures required by paragraph 86 of HKAS 37.

13 When a contributor accounts for its interest in the fund in accordance with paragraph 9, it shall make the disclosures required by paragraph 85(c) of HKAS 37.

Effective date

14 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies this Interpretation to a period beginning before 1 January 2006, it shall disclose that fact.

Transition

15 Changes in accounting policies shall be accounted for in accordance with the requirements of HKAS 8.

Appendix

Amendment to HKAS 39 *Financial Instruments: Recognition and Measurement*

The amendment in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies this Interpretation for an earlier period, the amendment shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standards.

Basis for Conclusions on HK(IFRIC)-Int 5

This Basis for Conclusions accompanies, but is not part of, HK(IFRIC)-Int 5.

The original text has been marked up to reflect the revision of HKAS 1 Presentation of Financial Statements *in 2007; new text is underlined and deleted text is struck through.*

HK(IFRIC) Interpretation 5 is based on IFRIC Interpretation 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*. In approving HK(IFRIC) Interpretation 5, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 5. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 5 and IFRIC Interpretation 5. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 5 referred to below generally correspond with those in HK(IFRIC) Interpretation 5.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

BC2 The IFRIC was informed that an increasing number of entities with decommissioning obligations are contributing to a separate fund established to help fund those obligations. The IFRIC was also informed that questions have arisen in practice over the accounting treatment of interests in such funds and that there is a risk that divergent practices may develop. The IFRIC therefore concluded that it should provide guidance to assist in answering the questions in paragraph 6, in particular on the accounting for the asset of the right to receive reimbursement from a fund. On the issue of whether the fund should be consolidated or equity accounted, the IFRIC concluded that the normal requirements of IAS 27 *Consolidated and Separate Financial Statements*, SIC-12 *Consolidation–Special Purpose Entities*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures* apply and that there is no need for interpretative guidance. The IFRIC published its proposed Interpretation on 15 January 2004 as D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds.*

BC3 Paragraphs 1-3 describe ways in which entities might arrange to fund their decommissioning obligations. Those that are within the scope of the Interpretation are specified in paragraphs 4-6.

Scope (paragraphs 4 and 5)

BC4 D4 did not precisely define the scope because the IFRIC believed that the large variety of schemes in operation would make any definition inappropriate. However, some respondents to D4 disagreed and commented that the absence of any definition made it unclear when the Interpretation should be applied. As a result, the IFRIC has specified the scope by identifying the features that make an arrangement a decommissioning fund. It has also described the different types of fund and the features that may (or may not) be present.

BC5 The IFRIC considered whether it should issue a wider Interpretation that addresses similar forms of reimbursement, or whether it should prohibit the application of the Interpretation to other situations by analogy. The IFRIC rejected any widening of the scope, deciding instead to concentrate on the matter referred to it. The IFRIC also decided that there was no reason to prohibit the application of the Interpretation to other situations by analogy and thus the hierarchy of criteria in paragraphs 7-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply, resulting in similar accounting for reimbursements under arrangements that are not decommissioning funds, but have similar features.

BC6 The IFRIC considered comments from respondents that a contributor may have an interest in the fund that extends beyond its right to reimbursement. In response, the IFRIC added clarification that a residual interest in a fund, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

Basis for consensus

Accounting for an interest in a fund (paragraphs 7-9)

BC7 The IFRIC concluded that the contributor should recognise a liability unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. This is because the contributor remains liable for the decommissioning costs. Additionally, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides that:

(a) when an entity remains liable for expenditure, a provision should be recognised even where reimbursement is available; and

(b) if the reimbursement is virtually certain to be received when the obligation is settled, then it should be treated as a separate asset.

BC8 In concluding that the contributor should recognise separately its liability to pay decommissioning costs and its interest in the fund, the IFRIC also noted the following:

(a) There is no legally enforceable right to set off the rights under the decommissioning fund against the decommissioning liabilities.

Also, given that the main objective is reimbursement, it is likely that settlement will not be net or simultaneous. Accordingly, treating these rights and liabilities as analogous to financial assets and financial liabilities would not result in offset because the offset criteria in IAS 32 *Financial Instruments: Disclosure and Presentation*[†] are not met.

(b) Treating the decommissioning obligation as analogous to a financial liability would not result in derecognition through extinguishment. If the fund does not assume the obligation for decommissioning, the criteria in IAS 39 for derecognition of financial liabilities through extinguishment are not met. At best, the fund acts like an in-substance defeasance that does not qualify for derecognition of the liability.

(c) It would not be appropriate to treat decommissioning funds as analogous to pension funds, which are presented net of the related liability. This is because, in allowing a net presentation for pension plans in IAS 19 *Employee Benefits,* the International Accounting Standards Board's predecessor organisation, IASC, stated that it believed the situation is 'unique to employee benefit plans and [it did] not intend to permit this net presentation for other liabilities if the conditions in IAS 32 and IAS 39 are not met' (IAS 19, Basis for Conclusions paragraph 68I).

BC9 As to the accounting for the contributor's interest in the fund, the IFRIC noted that some interests in funds would be within the scope of IAS 27, IAS 28, IAS 31 or SIC-12. As noted in paragraph BC2, the IFRIC concluded that, in such cases, the normal requirements of those Standards would apply and there is no need for interpretative guidance.

BC10 Otherwise, the IFRIC concluded that the contributor has an asset for its right to receive amounts from the fund.

The right to receive reimbursement from a fund and amendment to the scope of IAS 39

BC11 The IFRIC noted that under existing IFRSs, there are two forms of rights to reimbursement that would be accounted for differently:

(a) A contractual right to receive reimbursement in the form of cash. This meets the definition of a financial asset and is within the scope of IAS 39. Such a financial asset would be classified as an available-for-sale financial asset (unless accounted for using the fair value option) because it does not meet the definitions of a financial asset held for trading, a held-to-maturity investment or a loan or receivable.[*]

[†] In August 2005, IAS 32 has amended as IAS 32 Financial Instruments: *Presentation.*

[*] An interest in a decommissioning fund would not meet the definition of held for trading because it is not acquired or incurred principally for the purpose of selling or repurchasing it in the near term, nor of a held-to-maturity investment because it does not have fixed or determinable maturity. In addition, an interest in a fund is excluded from the definition of loans and receivables in IAS 39 since it is 'an interest acquired in a pool of assets that are not loans and receivables'.

(b) A right to reimbursement other than a contractual right to receive cash. This does not meet the definition of a financial asset and is within the scope of IAS 37.

BC12 The IFRIC concluded that both these forms of reimbursement have economically identical effects. Therefore accounting for both forms in the same way would provide relevant and reliable information to a user of the financial statements. However, the IFRIC noted that this did not appear possible under existing IFRSs because some such rights are within the scope of IAS 39, and others are not. Therefore, it asked the Board to amend the scope of IAS 39 to exclude rights to reimbursement for expenditure required to settle:

(a) a provision that has been recognised in accordance with IAS 37; and

(b) obligations that had been originally recognised as provisions in accordance with IAS 37, but are no longer provisions because their timing or amount is no longer uncertain. An example of such a liability is one that was originally recognised as a provision because of uncertainty about the timing of the cash outflow, but subsequently becomes another type of liability because the timing is now certain.

BC13 This amendment was approved by the Board and is set out in the Appendix of IFRIC 5*. As a result, all such rights to reimbursement are within the scope of IAS 37.

BC14 The IFRIC noted that paragraph 53 of IAS 37 specifies the accounting for rights to receive reimbursement. It requires this right to reimbursement to be separately recognised when it is virtually certain that reimbursement will be received if the contributor settles the obligation. The IFRIC also noted that this paragraph prohibits the recognition of an asset in excess of the recognised liability. For example, rights to receive reimbursement to meet decommissioning liabilities that have yet to be recognised as a provision are not recognised. Accordingly, the IFRIC concluded that when the right to reimbursement is virtually certain to be received if the contributor settles its decommissioning obligation, it should be measured at the lower of the amount of the decommissioning obligation recognised and the reimbursement right.

BC15 The IFRIC discussed whether the reimbursement right should be measured at:

(a) the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs (with any obligation to make good potential defaults of other contributors being treated separately as a contingent liability); or

(b) the fair value of the reimbursement right (which would normally be lower than (a) because of the risks involved, such as the possibility that the contributor may be required to make good defaults of other contributors).

BC16 The IFRIC noted that the right to reimbursement relates to a decommissioning obligation for which a provision would be recognised and measured in accordance with IAS 37. Paragraph 36 of IAS 37 requires such provisions to be measured at 'the best estimate of the expenditure required to settle the present obligation at the ~~balance sheet date~~<u>end of the reporting period</u>'. The IFRIC noted that the amount in paragraph BC15(a)—ie the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs—is the best estimate of the amount available to the contributor to reimburse it for expenditure it had incurred to pay for decommissioning. Thus, the amount of the asset recognised would be consistent with the amount of the liability recognised.

BC17 In contrast, the IFRIC noted that the amount in paragraph BC15(b)—ie the fair value of the reimbursement right—would take into account the factors such as liquidity that the IFRIC believed to be difficult to measure reliably. Furthermore, this amount would be lower than that in paragraph BC15(a) because it reflects the possibility that the contributor may be required to make potential additional contributions in the event of default by other contributors. The IFRIC noted that its decision that the obligation to make potential additional contributions should be treated as a contingent liability in accordance with IAS 37 (see paragraphs BC22-BC25) would result in double-counting of the risk of the additional contribution being required if the measure in paragraph BC15(b) were to be used.

BC18 Consequently, the IFRIC concluded that the approach in paragraph BC15(a) would provide the most useful information to users.

* The amendment has been incorporated into the text of IAS 39 as published in this volume.

The asset cap

BC19 Many respondents to D4 expressed concern about the ‘asset cap’ that is imposed by the requirement in paragraph 9. This asset cap limits the amount recognised as a reimbursement asset to the amount of the decommissioning obligation recognised. These respondents argued that rights to benefit in excess of this amount give rise to an additional asset, separate from the reimbursement asset. Such an additional asset may arise in a number of ways, for example:

(a) the contributor has the right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund.

(b) the contributor has the right to benefit from reduced contributions to the fund or increased benefits from the fund (eg by adding new sites to the fund for no additional contributions) in the future.

(c) the contributor expects to obtain benefit from past contributions in the future, based on the current and planned level of activity. However, because contributions are made before the decommissioning obligation is incurred, IAS 37 prevents recognition of an asset in excess of the obligation.

BC20 The IFRIC concluded that a right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund may be an equity instrument within the scope of IAS 39, in which case IAS 39 would apply. However, the IFRIC agreed that an asset should not be recognised for other rights to receive reimbursement from the fund. Although the IFRIC had sympathy with the concerns expressed by constituents that there may be circumstances in which it would seem appropriate to recognise an asset in excess of the reimbursement right, it concluded that it would be inconsistent with paragraph 53 of IAS 37 (which requires that ‘the amount recognised for the reimbursement should not exceed the amount of the provision’) to recognise this asset. The IFRIC also noted that the circumstances in which this additional asset exists are likely to be limited, and apply only when a contributor has restricted access to a surplus of fund assets that does not give it control, joint control or significant influence over a fund. The IFRIC expects that most such assets would not meet the recognition criteria in the *Framework* because they are highly uncertain and cannot be measured reliably.

BC21 The IFRIC also considered arguments that there should not be a difference between the treatment of a surplus when a fund is accounted for as a subsidiary, joint venture or associate, and when it is not. However, the IFRIC noted that, under IFRSs, restrictions on assets in subsidiaries, joint ventures or associates do not affect recognition of those assets. Hence it concluded that the difference in treatment between funds accounted for as subsidiaries, joint ventures or associates and those accounted for as a reimbursement right is inherent in IFRSs. The IFRIC also concluded that this is appropriate because, in the former case, the contributor exercises a degree of control not present in the latter case.

Obligations to make additional contributions (paragraph 10)

BC22 In some cases, a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor.

BC23 The IFRIC noted that by ‘joining’ the fund, a contributor may assume the position of guarantor of the contributions of the other contributors, and hence become jointly and severally liable for the obligations of other contributors. Such an obligation is a present obligation of the contributor, but the outflow of resources associated with it may not be probable. The IFRIC noted a parallel with the example in paragraph 29 of IAS 37, which states that ‘where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.’ Accordingly, the IFRIC concluded that a liability would be recognised by the contributor only if it is probable that it will make additional contributions. The IFRIC noted that such a contingent liability may arise both when the contributor’s interest in the fund is accounted for as a reimbursement right and when it is accounted for in accordance with IAS 27, IAS 28, IAS 31 or SIC-12.

BC24 The IFRIC considered the argument that an obligation to make good potential shortfalls of other contributors is a financial instrument (ie a financial guarantee) as defined in IAS 32 and hence should be accounted for in accordance with IAS 39. The grounds for this point of view are that the contributor has an obligation to deliver cash to the fund, and the fund has a right to receive cash from the contributor if a shortfall in contributions arises. However, the IFRIC noted that:

(a) a contractual obligation to make good shortfalls of other contributors is a financial guarantee. Financial guarantee contracts that provide for payments to be made if the debtor fails to make payment when due are excluded from the scope of IAS 39.

(b) when the obligation is not contractual, but rather arises as a result of regulation, it is not a financial liability as defined in IAS 32 nor is it within the scope of IAS 39.

BC25 Therefore, the IFRIC concluded that an obligation to make additional contributions in the event of specified circumstances should be treated as a contingent liability in accordance with IAS 37.

Disclosure (paragraphs 11-13)

BC26 The IFRIC noted that the contributor may not be able to access the assets of the fund (including cash or cash equivalents) for many years (eg until it undertakes the decommissioning), if ever. Therefore, the IFRIC concluded that the nature of the contributor's interest and the restriction on access should be disclosed. The IFRIC also concluded that this disclosure is equally relevant when a contributor's interest in a fund is accounted for by consolidation, proportional consolidation or using the equity method because the contributor's ability to access the underlying assets may be similarly restricted.

Effective date and transition (paragraphs 14 and 15)

BC27 D4 proposed that the Interpretation should be effective for annual periods beginning on a date set at three months after the Interpretation was finalised. The IFRIC considered the view of some respondents that the Interpretation should apply from 1 January 2005 (an earlier date) on the grounds that this is the date from which many entities will adopt IFRSs, and hence adopting the Interpretation at that time would promote comparability between periods. However, the IFRIC noted its general practice is to allow at least three months between finalising an Interpretation and its application, to enable entities to obtain the Interpretation and implement any necessary systems changes. In addition, the IFRIC considered the Board's concern that the amendment to IAS 39 issued as part of the Interpretation would change the 'stable platform' of Standards that are in force for entities that will apply IFRSs for the first time in 2005. Therefore, the IFRIC decided to require that the Interpretation should be applied for annual periods beginning on or after 1 January 2006, with earlier application encouraged.

BC28 The IFRIC observed that the implementation of the Interpretation is not expected to be problematic. Therefore, the IFRIC concluded that IAS 8 should apply. Respondents to D4 did not disagree with this conclusion.

Appendix
Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IFRIC 5 is amended as described below.

In paragraph BC6 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' and in paragraphs BC12, BC20 and BC24 the first reference in each to 'IAS 39' are footnoted as follows:

* In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

In paragraph BC11 a footnote is added to the reference to 'IAS 39' as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

HK(IFRIC)-Int 7

~~Issued January 2006~~Revised July 2010

Effective for annual periods
beginning on or after 1 March 2006

HK(IFRIC) Interpretation 7

Applying the Restatement Approach under HKAS 29 *Financial Reporting in Hyperinflationary Economies*

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

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Hong Kong (IFRIC) INTERPRETATION 7 *APPLYING THE RESTATEMENT APPROACH UNDER HKAS 29* FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

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Hong Kong (IFRIC) Interpretation 7 *Applying the Restatement Approach under HKAS 29* Financial Reporting in Hyperinflationary Economies (HK(IFRIC)-Int 7) is set out in paragraphs 1-6. HK(IFRIC)-Int 7 is accompanied by an illustrative example and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 7
Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies

References

- HKAS 12 *Income Taxes*
- HKAS 29 *Financial Reporting in Hyperinflationary Economies*

Background

1 This Interpretation provides guidance on how to apply the requirements of HKAS 29 in a reporting period in which an entity identifies[*] the existence of hyperinflation in the economy of its functional currency, when that economy was not hyperinflationary in the prior period, and the entity therefore restates its financial statements in accordance with HKAS 29.

Issues

2 The questions addressed in this Interpretation are:

(a) how should the requirement "… stated in terms of the measuring unit current at the ~~balance sheet date~~end of the reporting period" in paragraph 8 of HKAS 29 be interpreted when an entity applies the Standard?

(b) how should an entity account for opening deferred tax items in its restated financial statements?

Conclusions

3 In the reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, not having been hyperinflationary in the prior period, the entity shall apply the requirements of HKAS 29 as if the economy had always been hyperinflationary. Therefore, in relation to non-monetary items measured at historical cost, the entity's opening ~~balance sheet~~statement of financial position at the beginning of the earliest period presented in the financial statements shall be restated to reflect the effect of inflation from the date the assets were acquired and the liabilities were incurred or assumed until the ~~closing balance sheet date of the reporting period~~end of the reporting period. For non-monetary items carried in the opening ~~balance sheet~~statement of financial position at amounts current at dates other than those of acquisition or incurrence, that restatement shall reflect instead the effect of inflation from the dates those carrying amounts were determined until the ~~closing balance sheet date of the reporting period~~end of the reporting period.

4 At the ~~closing balance sheet date~~end of the reporting period, deferred tax items are recognised and measured in accordance with HKAS 12. However, the deferred tax figures in the opening ~~balance sheet~~statement of financial position for the reporting period shall be determined as follows:

(a) the entity remeasures the deferred tax items in accordance with HKAS 12 after it has restated the nominal carrying amounts of its non-monetary items at the date of the opening ~~balance sheet~~statement of financial position of the reporting period by applying the measuring unit at that date.

[*] The identification of hyperinflation is based on the entity's judgement of the criteria in paragraph 3 of HKAS 29.

(b) the deferred tax items remeasured in accordance with (a) are restated for the change in the measuring unit from the date of the opening ~~balance sheet~~statement of financial position of the reporting period to the ~~closing balance sheet date of that period~~end of that reporting period.

The entity applies the approach in (a) and (b) in restating the deferred tax items in the opening ~~balance sheet~~statement of financial position of any comparative periods presented in the restated financial statements for the reporting period in which the entity applies HKAS 29.

5 After an entity has restated its financial statements, all corresponding figures in the financial statements for a subsequent reporting period, including deferred tax items, are restated by applying the change in the measuring unit for that subsequent reporting period only to the restated financial statements for the previous reporting period.

Effective date

6 An entity shall apply this Interpretation for annual periods beginning on or after 1 March 2006. Earlier application is encouraged. If an entity applies this Interpretation to financial statements for a period beginning before 1 March 2006, it shall disclose that fact.

IFRIC Interpretation 7
Illustrative Example

This example accompanies, but is not part of, IFRIC 7.

IE1 This example illustrates the restatement of deferred tax items when an entity restates for the effects of inflation under IAS 29 *Financial Reporting in Hyperinflationary Economies*. As the example is intended only to illustrate the mechanics of the restatement approach in IAS 29 for deferred tax items, it does not illustrate an entity's complete IFRS financial statements.

Facts

IE2 An entity's IFRS ~~balance sheet~~statement of financial position at 31 December 20X4 (before restatement) is as follows:

Note	~~**Balance sheet**~~**Statement of financial position**	**20X4**[(a)]	20X3
		CU million	CU million
	ASSETS		
1	Property, plant and equipment	300	400
	Other assets	XXX	XXX
	Total assets	XXX	XXX
	EQUITY AND LIABILITIES		
	Total equity	XXX	XXX
	Liabilities		
2	Deferred tax liability	30	20
	Other liabilities	XXX	XXX
	Total liabilities	XXX	XXX
	Total equity and liabilities	XXX	XXX

Notes

1 *Property, plant and equipment*

All items of property, plant and equipment were acquired in December 20X2. Property, plant and equipment are depreciated over their useful life, which is five years.

2 *Deferred tax liability*

The deferred tax liability at 31 December 20X4 of CU30 million is measured as the taxable temporary difference between the carrying amount of property, plant and equipment of 300 and their tax base of 200. The applicable tax rate is 30 per cent.

Similarly, the deferred tax liability at 31 December 20X3 of CU20 million is measured as the taxable temporary difference between the carrying amount of property, plant and equipment of CU400 and their tax base of CU333.

(a) In this example, monetary amounts are denominated in 'currency units (CU)'.

IE3 Assume that the entity identifies the existence of hyperinflation in, for example, April 20X4 and therefore applies IAS 29 from the beginning of 20X4. The entity restates its financial statements on the basis of the following general price indices and conversion factors:

	General price indices	**Conversion factors at 31 Dec 20X4**
December 20X2[(a)]	95	2.347
December 20X3	135	1.652
December 20X4	223	1.000

(a) For example, the conversion factor for December 20X2 is 2.347=223/95.

Restatement

IE4 The restatement of the entity's 20X4 financial statements is based on the following requirements:

- Property, plant and equipment are restated by applying the change in a general price index from the date of acquisition to the ~~balance sheet date~~end of the reporting period to their historical cost and accumulated depreciation.
- Deferred taxes should be accounted for in accordance with IAS 12 *Income Taxes*.
- Comparative figures for property, plant and equipment for the previous reporting period are presented in terms of the measuring unit current at the end of the reporting period.
- Comparative deferred tax figures should be measured in accordance with paragraph 4 of the Interpretation.

IE5 Therefore the entity restates its ~~balance sheet~~statement of financial position at 31 December 20X4 as follows:

Note	**~~Balance sheet~~Statement of financial position (restated)**	**20X4**	20X3
		CU million	CU million
	ASSETS		
1	Property, plant and equipment	704	939
	Other assets	XXX	XXX
	Total assets	XXX	XXX
	EQUITY AND LIABILITIES		
	Total equity	XXX	XXX
	Liabilities		
2	Deferred tax liability	151	117
	Other liabilities	XXX	XXX
	Total liabilities	XXX	XXX
	Total equity and liabilities	XXX	XXX

Notes

1 *Property, plant and equipment*

All items of property, plant and equipment were purchased in December 20X2 and depreciated over a five-year period. The cost of property, plant and equipment is restated to reflect the change in the general price level since acquisition, ie the conversion factor is 2.347 (223/95).

	Historical CU million	Restated CU million
Cost of property, plant and equipment	500	1,174
Depreciation 20X3	(100)	(235)
Carrying amount 31 December 20X3	400	939
Depreciation 20X4	(100)	(235)
Carrying amount 31 December 20X4	300	704

continued…

…continued

2. Deferred tax liability

The nominal deferred tax liability at 31 December 20X4 of CU30 million is measured as the taxable temporary difference between the carrying amount of property, plant and equipment of CU300 and their tax base of CU200. Similarly, the deferred tax liability at 31 December 20X3 of CU20 million is measured as the taxable temporary difference between the carrying amount of property, plant and equipment of CU400 and their tax base of CU333. The applicable tax rate is 30 per cent.

In its restated financial statements, at the ~~balance sheet date~~end of the reporting period the entity remeasures deferred tax items in accordance with the general provisions in IAS 12, ie on the basis of its restated financial statements. However, because deferred tax items are a function of carrying amounts of assets or liabilities and their tax bases, an entity cannot restate its comparative deferred tax items by applying a general price index. Instead, in the reporting period in which an entity applies the restatement approach under IAS 29, it (a) remeasures its comparative deferred tax items in accordance with IAS 12 after it has restated the nominal carrying amounts of its non-monetary items at the date of the opening ~~balance sheet~~statement of financial position of the current reporting period by applying the measuring unit at that date, and (b) restates the remeasured deferred tax items for the change in the measuring unit from the date of the opening ~~balance sheet~~statement of financial position of the current period up to the ~~balance sheet date~~end of the reporting period.

In the example, the restated deferred tax liability is calculated as follows:

	CU million
At the ~~balance sheet date~~end of the reporting period:	
Restated carrying amount of property, plant and equipment (see note 1)	704
Tax base	(200)
Temporary difference	504
@ 30 per cent tax rate = Restated deferred tax liability 31 December 20X4	151
Comparative deferred tax figures:	
Restated carrying amount of property, plant and equipment [either 400 x 1.421 (conversion factor 1.421=135/95), or 939/1.652 (conversion factor 1.652=223/135)]	568
Tax base	(333)
Temporary difference	235
@ 30 per cent tax rate = Restated deferred tax liability 31 December 20X3 at the general price level at the end of 20X3	71
Restated deferred tax liability 31 December 20X3 at the general price level at the end of 20X4 (conversion factor 1.652=223/135)	117

IE6 In this example, the restated deferred tax liability is increased by CU34 to CU151 from 31 December 20X3 to 31 December 20X4. That increase, which is included in profit or loss in 20X4, reflects (a) the effect of a change in the taxable temporary difference of property, plant and equipment, and (b) a loss of purchasing power on the tax base of property, plant and equipment. The two components can be analysed as follows:

	CU million
Effect on deferred tax liability because of a decrease in the taxable temporary difference of property, plant and equipment (-CU235 + CU133) x 30%	31
Loss on tax base because of inflation in 20X4 (CU333 x 1.652 - CU333) x 30%	(65)
Net increase of deferred tax liability	(34)
Debit to profit or loss in 20X4	34

The loss on tax base is a monetary loss. Paragraph 28 of IAS 29 explains this as follows:

> The gain or loss on the net monetary position is included in net income. The adjustment to those assets and liabilities linked by agreement to changes in prices made in accordance with paragraph 13 is offset against the gain or loss on net monetary position. Other ~~income statement items~~income and expense items, such as interest income and expense, and foreign exchange differences related to invested or borrowed funds, are also associated with the net monetary position. Although such items are separately disclosed, it may be helpful if they are presented together with the gain or loss on net monetary position in the ~~income statement~~statement of comprehensive income.

Basis for Conclusions on IFRIC Interpretation 7 *Applying the Restatement Approach under HKAS 29* Financial Reporting in Hyperinflationary Economies

This Basis for Conclusions accompanies, but is not part of, IFRIC 7.

HK(IFRIC)-Int 7 is based on IFRIC Interpretation 7 *Applying the Restatement Approach under IAS 29* Financial Reporting in Hyperinflationary Economies. In approving HK(IFRIC)-Int 7, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 7. Accordingly, there are no significant differences between HK(IFRIC)-Int 7 and IFRIC Interpretation 7. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 7 referred to below generally correspond with those in HK(IFRIC)-Int 7.

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

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 The IFRIC was asked for guidance on how an entity should restate its financial statements when it starts to apply IAS 29 *Financial Reporting in Hyperinflationary Economies*. There was uncertainty whether the opening balance sheet at the beginning of the reporting period should be restated to reflect changes in prices before that date.

BC3 In addition, there was uncertainty about the measurement of comparative deferred tax items in the opening balance sheet. IAS 29 states that at the balance sheet date deferred tax items of the restated financial statements should be measured in accordance with IAS 12 *Income Taxes*. However, it was not clear how an entity should account for the corresponding deferred tax figures.

BC4 In response, the IFRIC developed and published Draft Interpretation D5 *Applying IAS 29* Financial Reporting in Hyperinflationary Economies *for the First Time* for public comment in March 2004. It received 30 letters in response to the proposals.

Basis for consensus

The restatement approach

BC5 In developing D5, the IFRIC observed that the purpose of restating financial statements in hyperinflationary economies in accordance with IAS 29 is to reflect the effect on an entity of changes in general purchasing power. Paragraph 2 of IAS 29 states:

> In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading.

This purpose applies to the financial statements of the first reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency as well as to subsequent reporting periods (if the criteria for a hyperinflationary economy are still met).

BC6 The IFRIC considered the meaning of paragraph 4 of IAS 29, which states:

> … this Standard applies to the financial statements of any entity from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports.

The IFRIC noted that some may interpret this provision as restricting the restatement of an entity's opening balance sheet in the reporting period in which it identifies the existence of hyperinflation. Consequently, the opening balance sheet should be restated to reflect the change in a general price index for the reporting period only and not for changes in a general price index before the beginning of the reporting period, even though some balance sheet items may have been acquired or assumed before that date. However, the IFRIC also noted that paragraph 34 of IAS 29 requires:

> *Corresponding figures for the previous reporting period*, whether they were based on a historical cost approach or a current cost approach, are restated by applying a general price index so that the comparative financial statements are *presented in terms of the measuring unit current at the end of the reporting period*. Information that is disclosed in respect of earlier periods is also expressed in terms of the measuring unit current at the end of the reporting period... [emphasis added]

BC7 The IFRIC considered a possible inconsistency between the restriction in paragraph 4 of IAS 29 and the requirement in paragraph 34. The IFRIC noted that paragraph 4 is a scope paragraph, which identifies when an entity has to comply with the Standard. The paragraph clarifies that an entity applies the requirements of the Standard to its financial statements from the beginning of the reporting period to the balance sheet date and not only from the date when it identifies the existence of hyperinflation. However, paragraph 4 does not deal with the restatement and presentation of the financial statements (either at the balance sheet date or in relation to the comparative figures). Hence, paragraph 4 of IAS 29 does not exclude from the restatement of an entity's opening balance sheet changes in the general price level before the beginning of the reporting period in which the entity identifies the existence of hyperinflation.

BC8 The IFRIC concluded that, in the context of the purpose of the Standard, the restatement of the financial statements for the reporting period in which an entity identifies the existence of hyperinflation should be consistent with the restatement approach applied in subsequent reporting periods.

BC9 Some respondents to D5 expressed concerns about whether the restatement approach in IAS 29 was always practicable for preparers and whether it provided decision-useful information to users. Though the IFRIC understood those concerns, the IFRIC observed that such concerns reflected broader aspects related to the accounting for hyperinflation in general, rather than how an entity has to apply the current Standard.

BC10 Nevertheless, the IFRIC considered how an entity should apply the Standard if, for example, detailed records of the acquisition dates of items of property, plant and equipment are not available. The IFRIC noted that, in those circumstances, paragraph 16 of IAS 29 states:

> … In these rare circumstances, it may be necessary, in the first period of application of this Standard, to use an independent professional assessment of the value of the items as the basis for their restatement.

The IFRIC also noted that a similar exemption exists when a general price index may not be available. Paragraph 17 of IAS 29 states:

> … In these circumstances, it may be necessary to use an estimate based, for example, on the movements in the exchange rate between the functional currency and a relatively stable foreign currency.

BC11 The IFRIC observed that, in developing IFRS 1 *First-time Adoption of International Financial Reporting Standards*, the International Accounting Standards Board discussed whether IFRS 1 should exempt first-time adopters of IFRSs from the effects of restatement in their first IFRS financial statements. Paragraph BC67 of IFRS 1 states:

> 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.

BC12 However, the IFRIC also observed that first-time adopters of IFRSs could use, for example, the fair value at transition date as deemed cost for property, plant and equipment, and, in some instances, also for investment property and intangible assets. Hence, if a first-time adopter that would otherwise have to apply IAS 29 at its transition to IFRSs applies the fair value measurement exemption of IFRS 1, it would apply IAS 29 to periods only after the date for which the fair value was determined. Such remeasurements would therefore reduce the need for a first-time adopter to restate its financial statements.

BC13 The IFRIC noted that the exemptions from the general restatement approach for preparers that already apply IFRSs, as stated in paragraph BC10 above, apply only in specific circumstances, whereas a first-time adopter may always elect to use the fair value remeasurement exemption for property, plant and equipment in IFRS 1. Nevertheless, the IFRIC concluded that the application of the exemptions in the Standards is clear and, therefore, extending the exemptions in IAS 29 to permit preparers that already apply IFRSs to elect fair value remeasurement of property, plant and equipment when applying the restatement approach under IAS 29 would require amendments of the Standard itself, rather than an Interpretation.

BC14 Respondents to D5 also argued that the procedures, as proposed to be clarified, are inconsistent with the accounting for a change in functional currency under IAS 21 *The Effect of Changes in Foreign Exchange Rates*, which in their view is comparable to moving into a state of hyperinflation. Moreover, they noted that retrospective application is also inconsistent with the US GAAP approach, which accounts for a change in hyperinflation status prospectively.

BC15 In relation to the reference to a change in functional currency, the IFRIC observed that the existence of hyperinflation may (but not necessarily should) initiate such a change. The IFRIC noted that a change in functional currency is a change in the currency that is normally used to determine the pricing of an entity's transactions. As clarified in paragraph BC5 above, the purpose of restatement for the effects of hyperinflation is to reflect the effect of changes in purchasing power in the economy of an entity's functional currency. Therefore, the IFRIC did not believe that the application of accounting for hyperinflation should be based on the accounting for the change in an entity's functional currency.

BC16 The IFRIC also observed that respondents' reference to prospective application under US GAAP reflects requirements only for investments in foreign entities in hyperinflationary economies. In this case, paragraph 11 of SFAS 52 *Foreign Currency Translation* states:

> The financial statements of a foreign entity in a highly inflationary economy shall *be remeasured as if the functional currency were the reporting currency*. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 10…[emphasis added]

Therefore, under US GAAP a foreign entity's financial statements are remeasured into its investor's functional currency. The IFRIC noted that this approach is different from the restate/translate approach under IFRSs. US GAAP provides different guidance for reporting entities operating with a hyperinflationary functional currency. APB Statement No. 3 *Financial Statements Restated for General Price-Level Changes* is also based on a restatement approach, and would require retrospective application, as under IAS 29. The IFRIC observed that for the purpose of presenting comparative amounts in a different presentation currency under IFRSs paragraphs 42(b) and 43 of IAS 21 apply. In such instances, an entity will have relief from the required restatement of comparatives under IAS 29. Paragraph BC22 of IAS 21 explains the reasoning for this specific exemption as follows:

> … If exchange rates fully reflect differing price levels between the two economies to which they relate, the SIC-30 approach will result in the same amounts for the comparatives as were reported as current year amounts in the prior year financial statements. Furthermore, the Board noted that in the prior year, the relevant amounts had been already expressed in the non-hyperinflationary presentation currency, and there was no reason to change them.

BC17 D5 proposed that applying the restatement approach under IAS 29 should be regarded as a change in circumstances, rather than a change in accounting policy. Some respondents to D5 believed this was inconsistent. This is because IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 16, states that a change in circumstances is not a change in accounting policy and an entity would not apply IAS 29 retrospectively. However, the IFRIC observed that IAS 29 contains specific requirements on this point, as noted in paragraphs BC5-BC16 above. The IFRIC concluded that the opening balance sheet for the reporting period in which an entity identifies the existence of hyperinflation ought to be restated as if the entity had always applied the restatement approach under IAS 29. The IFRIC reconfirmed its view that this treatment is similar to the retrospective application of a change in accounting policy described in IAS 8.

Deferred tax items

BC18 The IFRIC was asked for guidance on the accounting for deferred tax items when an entity restates its financial statements according to IAS 29. In particular, the IFRIC was asked for guidance on measuring deferred tax items in the opening balance sheet for the reporting period in which an entity identifies the existence of hyperinflation.

BC19 The IFRIC observed that paragraph 32 of IAS 29 states:

> The restatement of financial statements in accordance with this Standard may give rise to differences between the carrying amount of individual assets and liabilities in the balance sheet and their tax bases. These differences are accounted for in accordance with IAS 12 *Income Taxes*.

Therefore, at the closing balance sheet date of the reporting period an entity remeasures its deferred tax items on the basis of the restated financial statements, rather than by applying the general restatement provisions for monetary items or non-monetary items. However, the IFRIC noted that it was not clear how an entity should account for its comparative deferred tax items.

BC20 In developing D5, the IFRIC considered the following options:

(a) restatement of deferred tax items as monetary items;

(b) restatement of deferred tax items as non-monetary items; or

(c) remeasurement of deferred tax items as if the economy of the entity's functional currency had always been hyperinflationary.

BC21 D5 proposed clarifying that deferred tax items are neither clearly monetary nor non-monetary in nature. This was because deferred tax items are determined by the assets' (and liabilities') relative carrying amounts and tax bases. However, some respondents to D5 objected to that view, for various reasons. Some argued that deferred tax items, by nature, are received or paid in a fixed or determinable number of units of currency, and so should be considered as monetary items in accordance with paragraph 8 of IAS 21. Others noted that general practice is to classify deferred taxes as non-monetary items.

BC22 When considering respondents' comments the IFRIC confirmed that its conclusion in paragraph BC17 above should also apply to deferred tax items. In other words, the deferred tax items in the opening balance sheet for the reporting period in which an entity identifies the existence of hyperinflation should be calculated as if the environment had always been hyperinflationary, ie option (c) in paragraph BC20. Although the IFRIC acknowledged that deferred tax items may meet the definition of monetary items it noted that the purposes of option (c) would not be achieved if opening deferred tax items were restated in the same manner as applied generally for monetary items.

BC23 The IFRIC observed that some respondents to D5 suggested that deferred tax items in the opening balance sheet should be remeasured after restating the opening balance sheet with the measurement unit current at the closing balance sheet date of the reporting period. In the IFRIC's view, that proposal would (in case of a deferred tax liability) overstate the deferred tax item recognised in the opening balance sheet and, accordingly, understate the costs recognised in the reporting period. This is because the loss on the tax base caused by the inflation in the reporting period would be recognised directly in opening equity. The IFRIC illustrated this by the following example:

> At the end of Year 1, a non-monetary asset is restated at the measurement unit current at that date. Its restated amount is CU1,000* and its tax base is CU500. If the tax rate is 30 per cent, the entity would remeasure a deferred tax liability of CU150. In Year 2 inflation is 100 per cent. Assuming that nothing has changed the entity would, in its restated financial statements, recognise an asset of CU2,000 (both at the closing balance sheet date of the reporting period and in the comparative figures). At the closing balance sheet date, the deferred tax liability is remeasured at CU450 ((CU2,000 - CU500) x 0.3). However, if the comparative deferred tax liability is remeasured after restating the asset by the measuring unit current at the closing balance sheet date of the reporting period, the entity should recognise an opening deferred tax liability of CU450, and there would be no impact on profit or loss (CU450 - CU450). On the other hand, if the comparatives are stated as proposed in D5, the restated opening deferred tax liability would be CU300 ((CU1,000 - CU500) x 0.3) x 100% + CU150). Accordingly, the entity should recognise a loss of CU150 (CU450 - CU300), which is the loss of purchasing power on the tax base in the reporting period.

* In this example monetary amounts are demonstrated in 'currency units (CU)'.

BC24 The IFRIC observed that paragraph 18 of Appendix A to IAS 12 explains:[*]

> Non-monetary assets are restated in terms of the measuring unit current at the balance sheet date (see IAS 29 *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes. *(notes: (1) the deferred tax is charged in the income statement;[†] and (2) if, in addition to the restatement, the non-monetary assets are also revalued, the deferred tax relating to the revaluation is charged to equity[§] and the deferred tax relating to the restatement is charged in the income statement.)*

BC25 Consequently, the IFRIC confirmed its conclusion that restatement of comparative deferred tax items would require an entity, first, to remeasure its deferred tax items on the basis of the financial statements of the previous reporting period, which have been restated by applying a general price index reflecting the price level at the end of that period. Secondly, the entity should restate those calculated deferred tax items by the change in the general price level for the reporting period.

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* Paragraph 18 has been amended as a consequence of the changes made by IAS 1 *Presentation of Financial Statements* (as revised in 2007).

† IAS 1 (revised 2007) requires an entity to present all income and expense items in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

§ Under IAS 1 (revised 2007), such effect is recognised in other comprehensive income.

HK(IFRIC)-Int 8
Revised July ~~2009~~2010

Effective for annual periods
beginning on or after 1 May 2006

HK(IFRIC) Interpretation 8

Scope of HKFRS 2

Amendments to HKFRS 2 *Share-based Payment* — Group Cash-settled Share-based Payment Transactions issued in July 2009 is applicable for annual periods beginning on or after 1 January 2010 and supersedes this HK(IFRIC) Interpretation.

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Hong Kong (IFRIC) Interpretation 8 *Scope of HKFRS 2* (HK(IFRIC)-Int 8) is set out in paragraphs 1-14. HK(IFRIC)-Int 8 is accompanied by an Illustrative Example and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 8
Scope of HKFRS 2

References

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKFRS 2 *Share-based Payment*

Background

1 HKFRS 2 applies to share-based payment transactions in which the entity receives or acquires goods or services. 'Goods' includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets (HKFRS 2, paragraph 5). Consequently, except for particular transactions excluded from its scope, HKFRS 2 applies to all transactions in which the entity receives non-financial assets or services as consideration for the issue of equity instruments of the entity. HKFRS 2 also applies to transactions in which the entity incurs liabilities, in respect of goods or services received, that are based on the price (or value) of the entity's shares or other equity instruments of the entity.

2 In some cases, however, it might be difficult to demonstrate that goods or services have been (or will be) received. For example, an entity may grant shares to a charitable organisation for nil consideration. It is usually not possible to identify the specific goods or services received in return for such a transaction. A similar situation might arise in transactions with other parties.

3 HKFRS 2 requires transactions in which share-based payments are made to employees to be measured by reference to the fair value of the share-based payments at grant date (HKFRS 2, paragraph 11).* Hence, the entity is not required to measure directly the fair value of the employee services received.

4 For transactions in which share-based payments are made to parties other than employees, HKFRS 2 specifies a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. In these situations, HKFRS 2 requires the transaction to be measured at the fair value of the goods or services at the date the entity obtains the goods or the counterparty renders service (HKFRS 2, paragraph 13). Hence, there is an underlying presumption that the entity is able to identify the goods or services received from parties other than employees. This raises the question of whether the HKFRS applies in the absence of identifiable goods or services. That in turn raises a further question: if the entity has made a share-based payment and the identifiable consideration received (if any) appears to be less than the fair value of the share-based payment, does this situation indicate that goods or services have been received, even though they are not specifically identified, and therefore that HKFRS 2 applies?

5 It should be noted that the phrase 'the fair value of the share-based payment' refers to the fair value of the particular share-based payment concerned. For example, an entity might be required by government legislation to issue some portion of its shares to nationals of a particular country, which may be transferred only to other nationals of that country. Such a transfer restriction may affect the fair value of the shares concerned, and therefore those shares may have a fair value that is less than the fair value of otherwise identical shares that do not carry such restrictions. In this situation, if the question in paragraph 4 were to arise in the context of the restricted shares, the

* Under HKFRS 2, all references to employees include others providing similar services.

phrase 'the fair value of the share-based payment' would refer to the fair value of the restricted shares, not the fair value of other, unrestricted shares.

Scope

6 HKFRS 2 applies to transactions in which an entity or an entity's shareholders have granted equity instruments* or incurred a liability to transfer cash or other assets for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity. This Interpretation applies to such transactions when the identifiable consideration received (or to be received) by the entity, including cash and the fair value of identifiable non-cash consideration (if any), appears to be less than the fair value of the equity instruments granted or liability incurred. However, this Interpretation does not apply to transactions excluded from the scope of HKFRS 2 in accordance with paragraphs 3–6 of that HKFRS.

Issue

7 The issue addressed in the Interpretation is whether HKFRS 2 applies to transactions in which the entity cannot identify specifically some or all of the goods or services received.

Conclusions

8 HKFRS 2 applies to particular transactions in which goods or services are received, such as transactions in which an entity receives goods or services as consideration for equity instruments of the entity. This includes transactions in which the entity cannot identify specifically some or all of the goods or services received.

9 In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case HKFRS 2 applies. In particular, if the identifiable consideration received (if any) appears to be less than the fair value of the equity instruments granted or liability incurred, typically this circumstance indicates that other consideration (ie unidentifiable goods or services) has been (or will be) received.

10 The entity shall measure the identifiable goods or services received in accordance with HKFRS 2.

11 The entity shall measure the unidentifiable goods or services received (or to be received) as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services received (or to be received).

12 The entity shall measure the unidentifiable goods or services received at the grant date. However, for cash-settled transactions, the liability shall be remeasured at ~~each reporting date~~the end of each reporting period until it is settled.

Effective date

13 An entity shall apply this Interpretation for annual periods beginning on or after 1 May 2006. Earlier application is encouraged. If an entity applies this Interpretation to a period beginning before 1 May 2006, it shall disclose that fact.

* These include equity instruments of the entity, the entity's parent and other entities in the same group as the entity.

Transition

14 An entity shall apply this Interpretation retrospectively in accordance with the requirements of HKAS 8, subject to the transitional provisions of HKFRS 2.

IFRIC Interpretation 8
Illustrative example

This example accompanies, but is not part of, IFRIC 8.

IE1 An entity granted shares with a total fair value of CU100,000* to parties other than employees who are from a particular section of the community (historically disadvantaged individuals), as a means of enhancing its image as a good corporate citizen. The economic benefits derived from enhancing its corporate image could take a variety of forms, such as increasing its customer base, attracting or retaining employees, or improving or maintaining its ability to tender successfully for business contracts.

IE2 The entity cannot identify the specific consideration received. For example, no cash was received and no service conditions were imposed. Therefore, the identifiable consideration (nil) is less than the fair value of the equity instruments granted (CU100,000).

IE3 Although the entity cannot identify any specific goods or services received, the circumstances indicate that goods or services have been (or will be) received, and therefore IFRS 2 applies.

IE4 In this situation, because the entity cannot identify the specific goods or services received, the rebuttable presumption in paragraph 13 of IFRS 2, that the fair value of the goods or services received can be estimated reliably, does not apply. The entity should instead measure the goods or services received by reference to the fair value of the equity instruments granted.

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

Basis for Conclusions on IFRIC Interpretation 8

This Basis for Conclusions accompanies, but is not part of, IFRIC 8.

HK(IFRIC)-Int 8 is based on IFRIC Interpretation 8 *Scope of IFRS 2*. In approving HK(IFRIC)-Int 8, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 8. Accordingly, there are no significant differences between HK(IFRIC)-Int 8 and IFRIC Interpretation 8. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 8 referred to below generally correspond with those in HK(IFRIC)-Int 8.

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 IFRS 2 *Share-based Payment* applies to share-based payment transactions in which the entity receives or acquires goods or services. However, in some situations, it might be difficult to demonstrate that the entity has received goods or services. This raises the question of whether IFRS 2 applies to such transactions.

BC3 This question arose in the context of particular transactions, similar to the transaction described in the Illustrative Example that accompanies the Interpretation. The IFRIC concluded that determining whether such transactions were within the scope of IFRS 2 raised a further question: if the entity has made a share-based payment and the identifiable consideration received (if any) appears to be less than the fair value of the share-based payment, does this situation indicate that goods or services have been received, even though those goods or services are not specifically identified, and therefore that IFRS 2 applies?

BC4 The IFRIC noted that, when the International Accounting Standards Board developed IFRS 2, the Board concluded that the directors of an entity would expect to receive some goods or services in return for equity instruments issued (IFRS 2 paragraph BC37). This implies that it is not necessary to identify the specific goods or services received in return for the equity instruments granted to conclude that goods or services have been (or will be) received. Furthermore, paragraph 8 of the Standard establishes that it is not necessary for the goods or services received to qualify for recognition as an asset in order for the share-based payment to be within the scope of IFRS 2. In this case, the Standard requires the cost of the goods or services received or receivable to be recognised as expenses.

BC5 Accordingly, the IFRIC concluded that the scope of IFRS 2 includes transactions in which the entity cannot identify some or all of the specific goods or services received. If the identifiable consideration received appears to be less than the fair value of the equity instruments granted or liability incurred, typically[*], this circumstance indicates that other consideration (ie unidentifiable goods or services) has been (or will be) received.

BC6 The IFRIC also noted that IFRS 2 presumes that the consideration received for share-based payments is consistent with the fair value of those share-based payments. For example, if the entity cannot estimate reliably the fair value of the goods or services received, IFRS 2 requires the entity to measure the fair value of the

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

goods or services received by reference to the fair value of the share-based payment made to acquire those goods or services.

BC7 The IFRIC noted that it is neither necessary nor appropriate to measure the fair value of goods or services as well as the fair value of the share-based payment for every transaction in which the entity receives goods or non-employee services. However, when the identifiable consideration received appears to be less than the fair value of the share-based payment, measurement of both the goods or services received and the share-based payment may be necessary in order to measure the value of the unidentifiable goods or services received.

BC8 Paragraph 13 of IFRS 2 stipulates a rebuttable presumption that identifiable goods or services received can be reliably estimated. The IFRIC noted that goods or services that are unidentifiable cannot be reliably measured and that this rebuttable presumption is relevant only for identifiable goods or services.

BC9 The IFRIC noted that when the goods or services received are identifiable, the measurement principles in IFRS 2 should be applied. When the goods or services received are unidentifiable, the IFRIC concluded that the grant date is the most appropriate date for the purposes of providing a surrogate measure of the unidentifiable goods or services received (or to be received).

BC10 The IFRIC noted that some transactions include identifiable and unidentifiable goods or services. In this case, it would be necessary to measure the fair value of the unidentifiable goods or services received at the grant date and to measure the identifiable goods or services in accordance with IFRS 2.

BC11 For cash-settled transactions in which unidentifiable goods or services are received, it is necessary to remeasure the liability at each subsequent reporting date in order to be consistent with IFRS 2.

BC12 The IFRIC noted that the IFRS 2 requirements in respect of the recognition of the expense arising from share-based payments would apply to identifiable and unidentifiable goods or services. Therefore, the IFRIC decided not to issue additional guidance on this point.

BC13 When considering the transitional provisions relating to first-time adopters applying the Interpretation, the IFRIC concluded that it was not necessary to amend IFRS 1 *First-time Adoption of International Financial Reporting Standards*, because the Interpretation will have no effect unless IFRS 2 is effective.

HK(IFRIC)-Int 9
Revised ~~May 2009~~July 2010

Effective for annual periods
beginning on or after 1 June 2006

HK(IFRIC) Interpretation 9

Reassessment of Embedded Derivatives

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Certified Public Accountants
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Hong Kong (IFRIC) Interpretation 9 *Reassessment of Embedded Derivatives* (HK(IFRIC)-Int 9) is set out in paragraphs 1-~~9~~11~~ and Appendices A-B~~. HK(IFRIC)-Int 9 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 9
Reassessment of Embedded Derivatives

References

- HKAS 39 *Financial Instruments: Recognition and Measurement*
- HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*
- HKFRS 3 *Business Combinations*

Background

1 HKAS 39 paragraph 10 describes an embedded derivative as 'a component of a hybrid (combined) instrument that also includes a non-derivative host contract–with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.'

2 HKAS 39 paragraph 11 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Scope

3 Subject to paragraphs 4 and 5 below, this Interpretation applies to all embedded derivatives within the scope of HKAS 39.

4 This Interpretation does not address remeasurement issues arising from a reassessment of embedded derivatives.

5 This Interpretation does not ~~address the acquisition of contracts with embedded derivatives in~~apply to embedded derivatives in contracts acquired in:

(a) a business combination (as defined in HKFRS 3 *Business Combinations* (as revised in 2008));

(b) a combination of entities or businesses under common control as described in paragraphs B1-B4 of HKFRS 3 (revised 2008); or

(c) the formation of a joint venture as defined in HKAS 31 *Interests in Joint Ventures*

~~n~~or their possible reassessment at the date of acquisition.*

* HKFRS 3 (as revised in 2008) addresses the acquisition of contracts with embedded derivatives in a business combination.

Issues

6 HKAS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. This Interpretation addresses the following issues:

(a) Does HKAS 39 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?

(b) Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts HKFRSs for the first time?

Conclusions

7 An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) a reclassification of a financial asset out of the fair value through profit or loss category, in which cases an ~~re~~assessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

7A The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through profit or loss category in accordance with paragraph 7 shall be made on the basis of the circumstances that existed on the later date of:

(a) when the entity first became a party to the contract; and

(b) a change in the terms of the contract that significantly modified the cash flows that otherwise would have been required under the contract.

For the purpose of this assessment paragraph 11(c) of HKAS 39 shall not be applied (ie the hybrid (combined) contract shall be treated as if it had not been measured at fair value with changes in fair value recognised in profit or loss). If an entity is unable to make this assessment the hybrid (combined) contract shall remain classified as at fair value through profit or loss in its entirety.

8 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph 7.

Effective date and transition

9 An entity shall apply this Interpretation for annual periods beginning on or after 1 June 2006. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 June 2006, it shall disclose that fact. The Interpretation shall be applied retrospectively.

10 *Embedded Derivatives* (Amendments to HK(IFRIC)-Int 9 and HKAS 39) issued in March 2009 amended paragraph 7 and added paragraph 7A. An entity shall apply those amendments for annual periods ending on or after 30 June 2009.

11 Paragraph 5 was amended by *Improvements to HKFRSs* issued in May 2009. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (as revised in 2008) for an earlier period, it shall apply the amendment for that earlier period and disclose that fact.

Basis for Conclusions on IFRIC Interpretation 9 *Reassessment of Embedded Derivatives*

This Basis for Conclusions accompanies, but is not part of, IFRIC 9.

HK(IFRIC)-Int 9 is based on IFRIC Interpretation 9 *Reassessment of Embedded Derivatives*. In approving HK(IFRIC)-Int 9, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 9. Accordingly, there are no significant differences between HK(IFRIC)-Int 9 and IFRIC Interpretation 9. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 9 referred to below generally correspond with those in HK(IFRIC)-Int 9.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 As explained below, the IFRIC was informed that uncertainty existed over certain aspects of the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* relating to the reassessment of embedded derivatives. The IFRIC published proposals on the subject in March 2005 as D15 *Reassessment of Embedded Derivatives* and developed IFRIC 9 after considering the thirty comment letters received.

BC3 IAS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative under the Standard. However, the issue arises whether IAS 39 requires an entity to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency. The Standard is silent on this issue and the IFRIC was informed that as a result there was a risk of divergence in practice.

BC4 The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph AG33(d) of IAS 39. Paragraph AG33(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(a) the functional currency of any substantial party to that contract;

(b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

BC5 Any of the currencies specified in (a)-(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related (because it was in one of the three categories in paragraph BC4) and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded

derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue is whether the entity should make such a reassessment.

BC5A In 2009 the International Accounting Standards Board observed that the changes to the definition of a business combination in the revisions to IFRS 3 *Business Combinations* (as revised in 2008) caused the accounting for the formation of a joint venture by the venturer to be within the scope of IFRIC 9. Similarly, the Board noted that common control transactions might raise the same issue depending on which level of the group reporting entity is assessing the combination.

BC5B The Board observed that during the development of the revised IFRS 3, it did not discuss whether it intended IFRIC 9 to apply to those types of transactions. The Board did not intend to change existing practice by including such transactions within the scope of IFRIC 9. Accordingly, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 5 of IFRIC 9 to clarify that IFRIC 9 does not apply to embedded derivatives in contracts acquired in a combination between entities or businesses under common control or the formation of a joint venture.

BC5C Some respondents to the exposure draft *Post-implementation Revisions to IFRIC Interpretations* published in January 2009 expressed the view that investments in associates should also be excluded from the scope of IFRIC 9. Respondents noted that paragraphs 20–23 of IAS 28 *Investments in Associates* state that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

BC5D In its redeliberations, the Board confirmed its previous decision that no scope exemption in IFRIC 9 was needed for investments in associates. However, in response to the comments received, the Board noted that reassessment of embedded derivatives in contracts held by an associate is not required by IFRIC 9 in any event. The investment in the associate is the asset the investor controls and recognises, not the underlying assets and liabilities of the associate.

Reassessment of embedded derivatives

BC6 The IFRIC noted that the rationale for the requirement in IAS 39 to separate embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances (such as those set out in paragraph BC5) are not ways to circumvent the Standard. The IFRIC therefore concluded that reassessment was not appropriate for such changes.

BC7 The IFRIC noted that as a practical expedient IAS 39 does not require the separation of embedded derivatives that are closely related. Many financial instruments contain embedded derivatives. Separating all of these embedded derivatives would be burdensome for entities. The IFRIC noted that requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

BC8 The IFRIC also recognised that although IAS 39 is silent on the issue of reassessment it gives relevant guidance when it states that for the types of contracts covered by paragraph AG33(b) the assessment of whether an embedded derivative is closely related is required only at inception. Paragraph AG33(b) states:

> An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest *when the contract is issued*, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money *at inception* and are not leveraged. [Emphasis added]

BC9 The IFRIC also considered the implications of requiring subsequent reassessment. For example, assume that an entity, when it first becomes a party to a contract, separately recognises a host asset and an embedded derivative liability. If the entity were required to reassess whether the embedded derivative was to be accounted for separately and if the entity concluded some time after becoming a party to the contract that the derivative was no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the IFRIC identified the following possibilities:

(a) the entity could remove the derivative from its balance sheet and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.

(b) the entity could leave the derivative as a separate item in the balance sheet. The issue would then arise as to when the item was to be removed from the balance sheet. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?

(c) the entity could combine the derivative (which is recognised at fair value) with the asset (which is recognised at amortised cost). This would alter both the carrying amount of the asset and its effective interest rate even though there had been no change in the economics of the whole contract. In some cases, it could also result in a negative effective interest rate.

The IFRIC noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

BC10 The IFRIC noted that IAS 39 requires an entity to assess whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at that date.

BC11 The IFRIC considered an alternative approach of making reassessment optional. It decided against this approach because it would reduce comparability of financial information. Also, the IFRIC noted that this approach would be inconsistent with the embedded derivative requirements in IAS 39 that either require or prohibit separation but do not give an option. Accordingly, the IFRIC concluded that reassessment should not be optional.

BC11A Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the International Accounting Standards Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. Some of those taking part in the public round-table meetings held by the Board and the US Financial Accounting Standards Board in November and December 2008 in response to the global financial crisis also raised that issue. They asked the Board to consider further amendments to IFRSs to prevent any practice developing whereby, following reclassification of a financial asset, embedded derivatives that should be separately accounted for are not.

BC11B In accordance with paragraph 7 of IFRIC 9, assessment of the separation of an embedded derivative after an entity first became a party to the contract is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. Constituents told the Board that some might interpret IFRIC 9 as prohibiting the separation of an embedded derivative on the reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category unless there is a concurrent change in its contractual terms.

BC11C The Board noted that when IFRIC 9 was issued, reclassifications out of the fair value through profit or loss category were prohibited and hence IFRIC 9 did not consider the possibility of such reclassifications.

BC11D The Board was clear that it did not intend the requirements to separate particular embedded derivatives from hybrid (combined) financial instruments to be circumvented as a result of the amendments to IAS 39 issued in October 2008. Therefore, the Board decided to clarify IFRIC 9 by amending paragraph 7.

BC11E The Board believes that unless assessment and separation of embedded derivatives is done when reclassifying hybrid (combined) financial assets out of the fair value through profit or loss category, structuring opportunities are created that the embedded derivative accounting requirements in IAS 39 were intended to prevent. This is because, by initially classifying a hybrid (combined) financial instrument as at fair value through profit or loss and later reclassifying it into another category, an entity can circumvent requirements for separation of an embedded derivative. The Board also noted that the only appropriate accounting for derivative instruments is to be included in the fair value through profit or loss category.

BC11F The Board decided also to clarify that an assessment on reclassification should be made on the basis of the circumstances that existed when the entity first became a party to the contract, or, if later, the date of a change in the terms of the contract that significantly modified the cash flows that otherwise would be required under the contract. This date is consistent with one of the stated purposes of embedded derivative accounting (ie preventing circumvention of the recognition and measurement requirements for derivatives) and provides some degree of comparability. Furthermore, because the terms of the embedded features in the hybrid (combined) financial instrument have not changed, the Board did not see a reason for arriving at an answer on separation different from what would have been the case at initial recognition of the hybrid (combined) contract (or a later date of a change in the terms of the contract). In addition, the Board clarified that paragraph 11(c) of IAS 39 should not be applied in assessing whether an embedded derivative requires separation. The Board noted that before reclassification the hybrid (combined) financial instrument is necessarily classified at fair value through profit or loss so that for the purpose of the assessment on reclassification this criterion is not relevant but would, if applied for assessments made in accordance with paragraph 7A of the Interpretation, always result in no embedded derivative being separated.

First-time adopters of IFRSs

BC12 In the Implementation Guidance with IFRS 1 *First-time Adoption of International Financial Reporting Standards*, paragraph IG55 states:

> When IAS 39 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IAS 39 reflect circumstances at that date (IAS 39, paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading (IAS 39, paragraph 12). This results in fair value measurement (except when the entity cannot determine a reliable fair value, see IAS 39, paragraph 46(c)), with changes in fair value recognised in profit or loss.

BC13 This guidance reflects the principle in IFRS 1 that a first-time adopter should apply IFRSs as if they had been in place from initial recognition. This is consistent with the general principle used in IFRSs of full retrospective application of Standards. The IFRIC noted that the date of initial recognition referred to in paragraph IG55 is the date when the entity first became a party to the contract and not the date of first-time adoption of IFRSs. Accordingly, the IFRIC concluded that IFRS 1 requires an entity to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of conditions at the date when the entity first became a party to the contract and not those at the date of first-time adoption.

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IFRIC 9 is amended as described below.

In paragraph BC2 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, amended the requirements in IAS 39 to identify and separately account for derivatives embedded in a financial host within the scope of IFRS 9. The requirements in IAS 39 continue to apply for derivatives embedded in non-financial hosts and financial hosts outside the scope of IFRS 9.

HK(IFRIC)-Int 10
~~Issued September 2006~~Revised July 2010

Effective for annual periods
beginning on or after 1 November 2006

HK(IFRIC) Interpretation 10

Interim Financial Reporting and Impairment

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APPENDIX: Amendments resulting from other Basis for Conclusions

Hong Kong (IFRIC) Interpretation 10 *Interim Financial Reporting and Impairment* (HK(IFRIC)-Int 10) is set out in paragraphs 1-10. HK(IFRIC)-Int 10 is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 10
Interim Financial Reporting and Impairment

References

- HKAS 34 *Interim Financial Reporting*
- HKAS 36 *Impairment of Assets*
- HKAS 39 *Financial Instruments: Recognition and Measurement*

Background

1 An entity is required to assess goodwill for impairment at ~~every reporting date~~the end of each reporting period, to assess investments in equity instruments and in financial assets carried at cost for impairment at ~~every balance sheet date~~the end of each reporting period and, if required, to recognise an impairment loss at that date in accordance with HKAS 36 and HKAS 39. However, at ~~a subsequent reporting or balance sheet date~~the end of a subsequent reporting period, conditions may have so changed that the impairment loss would have been reduced or avoided had the impairment assessment been made only at that date. This Interpretation provides guidance on whether such impairment losses should ever be reversed.

2 The Interpretation addresses the interaction between the requirements of HKAS 34 and the recognition of impairment losses on goodwill in HKAS 36 and certain financial assets in HKAS 39, and the effect of that interaction on subsequent interim and annual financial statements.

Issue

3 HKAS 34 paragraph 28 requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. It also states that 'the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.'

4 HKAS 36 paragraph 124 states that 'An impairment loss recognised for goodwill shall not be reversed in a subsequent period.'

5 HKAS 39 paragraph 69 states that 'Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.'

6 HKAS 39 paragraph 66 requires that impairment losses for financial assets carried at cost (such as an impairment loss on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured) should not be reversed.

7 The Interpretation addresses the following issue:

> Should an entity reverse impairment losses recognised in an interim period on goodwill and investments in equity instruments and in financial assets carried at cost if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at ~~a subsequent balance sheet date~~the end of a subsequent reporting period?

Conclusions

8 An entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost.

9 An entity shall not extend this conclusion by analogy to other areas of potential conflict between HKAS 34 and other standards.

Effective date and transition

10 An entity shall apply the Interpretation for annual periods beginning on or after 1 November 2006. Earlier application is encouraged. If an entity applies the Interpretation for a period beginning before 1 November 2006, it shall disclose that fact. An entity shall apply the Interpretation to goodwill prospectively from the date at which it first applied HKAS 36; it shall apply the Interpretation to investments in equity instruments or in financial assets carried at cost prospectively from the date at which it first applied the measurement criteria of HKAS 39.

Appendix

Amendments resulting from other HKFRSs

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

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

In the rubric the reference to 'paragraphs 1–10' is amended to 'paragraphs 1–11'. In the 'References' section, a reference to HKFRS 9 *Financial Instruments* is added. Paragraphs 1, 2, 7 and 8 are amended, paragraph 11 is added and paragraphs 5 and 6 are deleted as follows:

1 An entity is required to assess goodwill for impairment at the end of each reporting period~~, to assess investments in equity instruments and in financial assets carried at cost for impairment at the end of each reporting period~~ and, if required, to recognise an impairment loss at that date in accordance with HKAS 36 ~~and HKAS 39~~. However, …

2 The Interpretation addresses the interaction between the requirements of HKAS 34 and the recognition of impairment losses on goodwill in HKAS 36 ~~and certain financial assets in HKAS 39~~, and the effect of that interaction on subsequent interim and annual financial statements.

7 The Interpretation addresses the following issue:

> Should an entity reverse impairment losses recognised in an interim period on goodwill ~~and investments in equity instruments and in financial assets carried at cost~~ if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period?

8 An entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill ~~or an investment in either an equity instrument or a financial asset carried at cost~~.

11 HKFRS 9, issued in November 2009, amended paragraphs 1, 2, 7 and 8 and deleted paragraphs 5 and 6. An entity shall apply those amendments when it applies HKFRS 9.

Basis for Conclusions on IFRIC Interpretation 10 *Interim Financial Reporting and Impairment*

This Basis for Conclusions accompanies, but is not part of, IFRIC 10.

HK(IFRIC)-Int 10 is based on IFRIC Interpretation 10 *Interim Financial Reporting and Impairment*. In approving HK(IFRIC)-Int 10, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 10. Accordingly, there are no significant differences between HK(IFRIC)-Int 10 and IFRIC Interpretation 10. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 10 referred to below generally correspond with those in HK(IFRIC)-Int 10.

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 IAS 34 requires an entity to apply the same accounting policies in its interim financial statements as it applies in its annual financial statements. For annual financial statements, IAS 36 prohibits an entity from reversing an impairment loss on goodwill that it recognised in a prior annual period. Similarly, IAS 39 prohibits an entity from reversing in a subsequent annual period an impairment loss on an investment in an equity instrument or in a financial asset carried at cost. These requirements might suggest that an entity should not reverse in a subsequent interim period an impairment loss on goodwill or an investment in an equity instrument or in a financial asset carried at cost that it had recognised in a prior interim period. Such impairment losses would not be reversed even if no loss, or a smaller loss, would have been recognised had the impairment been assessed only at the end of the subsequent interim period.

BC3 However, IAS 34 requires year-to-date measures in interim financial statements. This requirement might suggest that an entity should reverse in a subsequent interim period an impairment loss it recognised in a prior interim period. Such impairment losses would be reversed if no loss, or a smaller loss, would have been recognised had the impairment been assessed only at the end of the subsequent interim period.

BC4 The IFRIC released Draft Interpretation D18 *Interim Financial Reporting and Impairment* for public comment in January 2006. It received more than 50 letters in response.

BC5 The IFRIC noted that many of the respondents believed that in attempting to address contradictions between standards, D18 was beyond the scope of the IFRIC. Some believed that the issue addressed could be better resolved by amending IAS 34. Before finalising its views, the IFRIC asked the International Accounting Standards Board to consider this point. The Board, however, did not wish to amend IAS 34 and asked the IFRIC to continue with its Interpretation.

BC6 Respondents to D18 were divided on whether the proposed Interpretation should prohibit the reversal of impairment losses on goodwill or investments in equity instruments or in financial assets carried at cost that had been recognised in interim periods. The IFRIC considered these responses but maintained its view that such losses should not be reversed in subsequent financial statements. The IFRIC observed that the wide divergence of views evident from respondents' letters underlined the need for additional guidance and it therefore decided to issue the Interpretation with few changes from D18.

BC7 The IFRIC considered the example of Entity A and Entity B, which each hold the same equity investment with the same acquisition cost. Entity A prepares quarterly interim financial statements and Entity B prepares half-yearly financial statements. The entities have the same year-end. The IFRIC noted that if there was a significant decline in the fair value of the equity instrument below its cost in the first quarter, Entity A would recognise an impairment loss in its first quarter interim financial statements. However, if the fair value of the equity instrument subsequently recovered, so that by the half-year date there had not been a significant decline in fair value below cost, Entity B would not recognise an impairment loss in its half-yearly financial statements if it tested for impairment only at its half-yearly reporting dates. Therefore, unless Entity A reversed the impairment loss that had been recognised in an earlier interim period, the frequency of reporting would affect the measurement of its annual results when compared with Entity B's approach. The IFRIC also noted that the recognition of an impairment loss could similarly be affected by the timing of the financial year-ends of the two entities.

BC8 The IFRIC noted paragraph B36 of Appendix B accompanying IAS 34, which provides examples of applying the general recognition and measurement principles of that standard and states that IAS 34 requires an entity to apply the same impairment testing, recognition, and reversal criteria at an interim date as it would at the end of its financial year.

BC9 The IFRIC concluded that the prohibitions on reversals of recognised impairment losses on goodwill in IAS 36 and on investments in equity instruments and in financial assets carried at cost in IAS 39 should take precedence over the more general statement in IAS 34 regarding the frequency of an entity's reporting not affecting the measurement of its annual results.

BC10 Furthermore, the IFRIC concluded that the rationale for the non-reversal of impairment losses relating to goodwill and investments in equity instruments, as set out in paragraph BC189 of IAS 36 and paragraph BC130 of IAS 39, applies at both interim and annual reporting dates.

BC11 The IFRIC considered a concern that this conclusion could be extended to other areas of potential conflict between IAS 34 and other standards. The IFRIC has not studied those areas and therefore has not identified any general principles that might apply both to the Interpretation and to other areas of potential conflict. The IFRIC therefore added a prohibition against extending the consensus by analogy to other areas of potential conflict between IAS 34 and other standards.

BC12 D18 proposed fully retrospective application. A number of comment letters stated that this could be read as being more onerous than the first-time adoption requirements of IAS 36. The IFRIC revised the wording of the transition requirements to make clear that the Interpretation should not be applied to periods before an entity's adoption of IAS 36 in the case of goodwill impairments and IAS 39 in the case of impairments of investments in equity instruments or in financial assets carried at cost.

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

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

The Basis for Conclusions on IFRIC 10 is amended as described below.

In paragraphs BC2 and BC9 the references to 'IAS 39' are footnoted as follows:

* In November 2009 the IASB amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. Consequently, no financial assets are carried at cost.

HK(IFRIC)-Int 11
Revised July ~~2009~~2010

Effective for annual periods
beginning on or after 1 March 2007

HK(IFRIC) Interpretation 11

HKFRS 2–Group and Treasury Share Transactions

Amendments to HKFRS 2 *Share-based Payment* — Group Cash-settled Share-based Payment Transactions issued in July 2009 is applicable for annual periods beginning on or after 1 January 2010 and supersedes this HK(IFRIC) Interpretation.

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

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Hong Kong (IFRIC) Interpretation 11 *HKFRS 2–Group and Treasury Share Transactions* (HK(IFRIC)-Int 11) is set out in paragraphs 1-13. HK(IFRIC)-Int 11 is accompanied by an Illustrative Example and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 11
HKFRS 2–Group and Treasury Share Transactions

References

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 32 *Financial Instruments: Presentation*
- HKFRS 2 *Share-based Payment*

Issues

1 This Interpretation addresses two issues. The first is whether the following transactions should be accounted for as equity-settled or as cash-settled under the requirements of HKFRS 2:

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

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

2 The second issue concerns share-based payment arrangements that involve two or more entities within the same group. For example, employees of a subsidiary are granted rights to equity instruments of its parent as consideration for the services provided to the subsidiary. HKFRS 2 paragraph 3 states that:

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

However, HKFRS 2 does not give guidance on how to account for such transactions in the individual or separate financial statements of each group entity.

3 Therefore, the second issue addresses the following share-based payment arrangements:

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

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

4 This Interpretation addresses how the share-based payment arrangements set out in paragraph 3 should be accounted for in the financial statements of the subsidiary that receives services from the employees.

5 There may be an arrangement between a parent and its subsidiary requiring the subsidiary to pay the parent for the provision of the equity instruments to the employees. This Interpretation does not address how to account for such an intragroup payment arrangement.

6 Although this Interpretation focuses on transactions with employees, it also applies to similar share-based payment transactions with suppliers of goods or services other than employees.

Conclusions

Share-based payment arrangements involving an entity's own equity instruments (paragraph 1)

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

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

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

Share-based payment arrangements involving equity instruments of the parent

A parent grants rights to its equity instruments to the employees of its subsidiary (paragraph 3(a))

8 Provided that the share-based arrangement is accounted for as equity-settled in the consolidated financial statements of the parent, the subsidiary shall measure the services received from its employees in accordance with the requirements applicable to equity-settled share-based payment transactions, with a corresponding increase recognised in equity as a contribution from the parent.

9 A parent may grant rights to its equity instruments to the employees of its subsidiaries, conditional upon the completion of continuing service with the group for a specified period. An employee of one subsidiary may transfer employment to another subsidiary during the specified vesting period without the employee's rights to equity instruments of the parent under the original share-based payment arrangement being affected. Each subsidiary shall measure the services received from the employee by reference to the fair value of the equity instruments at the date those rights to equity instruments were originally granted by the parent as defined in HKFRS 2 Appendix A, and the proportion of the vesting period served by the employee with each subsidiary.

10 Such an employee, after transferring between group entities, may fail to satisfy a vesting condition other than a market condition as defined in HKFRS 2 Appendix A, eg the employee leaves the group before completing the service period. In this case, each subsidiary shall adjust the amount previously recognised in respect of the services received from the employee in accordance with the principles in HKFRS 2 paragraph 19. Hence, if the rights to the equity instruments granted by the parent do not vest because of an employee's failure to meet a vesting condition other than a market condition, no amount is recognised on a cumulative basis for the services received from that employee in the financial statements of any subsidiary.

A subsidiary grants rights to equity instruments of its parent to its employees (paragraph 3(b))

11 The subsidiary shall account for the transaction with its employees as cash-settled. This requirement applies irrespective of how the subsidiary obtains the equity instruments to satisfy its obligations to its employees.

Effective date

12 An entity shall apply this Interpretation for annual periods beginning on or after 1 March 2007. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 March 2007, it shall disclose that fact.

Transition

13 An entity shall apply this Interpretation retrospectively in accordance with HKAS 8, subject to the transitional provisions of HKFRS 2.

Illustrative example

This example accompanies, but is not part of, IFRIC 11.

IE1 A parent grants 200 share options to each of 100 employees of its subsidiary, conditional upon the completion of two years' service with the subsidiary. The fair value of the share options on grant date is CU30 each*. At grant date, the subsidiary estimates that 80 per cent of the employees will complete the two-year service period. This estimate does not change during the vesting period. At the end of the vesting period, 81 employees complete the required two years of service. The parent does not require the subsidiary to pay for the shares needed to settle the grant of share options.

IE2 The share-based payment transaction in the consolidated financial statements of the parent is accounted for as equity-settled in accordance with IFRS 2.

IE3 As required by IFRIC 11 paragraph 8, over the two-year vesting period, the subsidiary measures the services received from the employees in accordance with the requirements applicable to equity-settled share-based payment transactions. Thus, the subsidiary measures the services received from the employees on the basis of the fair value of the share options at grant date. An increase in equity is recognised as a contribution from the parent in the financial statements of the subsidiary.

IE4 The journal entries recorded by the subsidiary for each of the two years are as follows:

Year 1

Dr	Remuneration expense		
(200 ×	100 × CU30 × 0.8/2)	CU240,000	
Cr	Equity (Contribution from the parent)		CU240,000

Year 2

Dr	Remuneration expense		
(200 ×	100 × CU30 × 0.81 – 240,000)	CU246,000	
Cr	Equity (Contribution from the parent)		CU246,000

* In this example monetary amounts are denominated in 'currency units (CU)'.

Basis for Conclusions on IFRIC Interpretation 11

This Basis for Conclusions accompanies, but is not part of, IFRIC 11.

HK(IFRIC)-Int 11 is based on IFRIC Interpretation 11 *IFRS 2–Group and Treasury Share Transactions*. In approving HK(IFRIC)-Int 11, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 11. Accordingly, there are no significant differences between HK(IFRIC)-Int 11 and IFRIC Interpretation 11. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 11 referred to below generally correspond with those in HK(IFRIC)-Int 11.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 The IFRIC released draft Interpretation D17 *IFRS 2–Group and Treasury Share Transactions* for public comment in May 2005. It received 40 letters in response.

Consensus (paragraphs 7-11)

Share-based payment arrangements involving an entity's own equity instruments (paragraph 7)

BC3 D17 proposed that, regardless of whether the entity chooses or is required to buy the equity instruments needed from another party to settle the share-based payment arrangement, the share-based payment transactions should be accounted for as equity-settled. The IFRIC's rationale was that the consideration for the services received is equity instruments of the entity (rather than a liability to transfer cash or other assets). For the same reason, the IFRIC proposed in D17 that, regardless of whether the employees' rights to the entity's equity instruments were granted by the entity itself or by its shareholders, or whether the obligations under the share-based payment arrangement were settled by the entity itself or its shareholders, the share-based payment transactions should be accounted for as equity-settled.

BC4 Of the 40 respondents to D17, only a small number disagreed with D17's proposal to treat the transactions as equity-settled.

BC5 For the reason stated in paragraph BC3, the IFRIC reaffirmed its view that the share-based payment transactions specified in IFRIC 11 paragraph 1(a) and (b) should be accounted for as equity-settled.

BC6 Some respondents asked the IFRIC to clarify whether an entity should recognise a financial liability when the entity enters into a contractual arrangement to acquire its own equity instruments. The IFRIC noted that the relevant requirements in IAS 32 *Financial Instruments: Presentation* are clear. Therefore, the IFRIC decided not to explain those requirements in the Interpretation.

Share-based payment arrangements involving equity instruments of the parent (paragraphs 8-11)

BC7 D17 addressed the following share-based payment arrangements in which two or more entities in the same group are involved:

(a) a parent grants rights to its equity instruments direct to its subsidiary's employees; and

(b) an entity grants rights to equity instruments of its parent to its employees.

A parent grants rights to its equity instruments to the employees of its subsidiary (paragraph 8)

BC8 The IFRIC noted that paragraph 3 of IFRS 2 *Share-based Payment* requires an entity to recognise as share-based payment arrangements transfers of equity instruments of the entity's parent to parties that have supplied goods or services to the entity. However, the IFRIC observed that, for the purposes of the preparation of the financial statements of the subsidiary, the transaction described in paragraph BC7(a) does not meet the definition of either an equity-settled share-based payment transaction or a cash-settled share-based payment transaction. In this situation, the equity instruments granted are not the equity instruments of the subsidiary and the subsidiary has no obligation to transfer cash or other assets to the employees.

BC9 Because the subsidiary does not have an obligation to deliver cash or other assets to the employees, the IFRIC proposed in D17 that it was not appropriate to account for the transaction as cash-settled in the financial statements of the subsidiary. Instead, the IFRIC suggested that the equity-settled basis was more consistent with the principles in IFRS 2.

BC10 Of the 40 respondents to D17, only a small number disagreed that the transaction should be accounted for as equity-settled in the financial statements of the subsidiary.

BC11 The IFRIC noted that the parent has an involvement in the arrangement by committing itself to provide the employees of the subsidiary with its equity instruments. To meet the requirement in IFRS 2 paragraph 3, the IFRIC believed that it was appropriate in this particular situation for the subsidiary in its own financial statements to apply the same measurement basis as the parent uses in its consolidated financial statements. Accordingly, the IFRIC concluded that, provided that the transaction is accounted for as equity-settled in the consolidated financial statements of the parent, the services received from the employees should be measured using the equity-settled basis in the financial statements of the subsidiary. Correspondingly, to reflect the parent's granting of rights to its equity instruments to the employees of the subsidiary, the IFRIC decided that the subsidiary should recognise in its equity a contribution from the parent equal to the amount at which the services from the employees are measured.

BC12 The IFRIC discussed whether the Interpretation should address how to account for an intragroup payment arrangement requiring the subsidiary to pay the parent for the provision of the equity instruments to the employees. The IFRIC decided not to address that issue because it did not wish to widen the scope of the Interpretation to an issue that relates to the accounting for intragroup payment arrangements generally.

A subsidiary grants rights to equity instruments of its parent to its employees (paragraph 11)

BC13 Although the subsidiary in the transaction described in paragraph BC7(b) has an obligation to its employees, the obligation is not determined on the basis of the price of its own equity instruments. Thus, the transaction does not meet the definition of a cash-settled share-based payment transaction in the financial statements of the subsidiary. In addition, because the equity instruments provided to the employees are not equity instruments of the subsidiary, the transaction does not meet the definition of an equity-settled share-based payment transaction either in the financial statements of the subsidiary.

BC14 D17 proposed that the subsidiary should account for the transaction with its employees as cash-settled in its own financial statements. The rationale was that the cash-settled basis was more consistent with the principles in IFRS 2 because the subsidiary has an obligation to provide its employees with the equity instruments of the parent, which are treated as assets of the subsidiary when the subsidiary acquires them.

BC15 Many respondents to D17 disagreed with the proposed treatment. They disagreed that the accounting treatments for the two types of arrangement described in paragraph BC7 should depend on which entity grants to the employees rights to equity instruments of the parent. In their view, regardless of whether the parent or the subsidiary grants those rights to the employees, in most cases the parent is the one that supplies the equity instruments to settle the obligation. They believed that it was not appropriate to require the subsidiary to apply different accounting treatments to transactions with the same substance. They had concerns that different accounting treatments would give entities opportunities to structure their intragroup transactions in order to achieve desired accounting results.

BC16 The IFRIC noted that arrangements described in paragraph BC7(a) and (b) might be the same in the consolidated financial statements of the parent, and also from the perspective of the employees who receive the equity instruments. However, from the perspective of the subsidiary, the IFRIC observed that the two arrangements are different. The IFRIC noted that under arrangement (a) the parent, rather than the subsidiary, has the obligation to provide its employees with the equity instruments, whereas under arrangement (b) it is the subsidiary that has that obligation.

BC17 In addition, the IFRIC clarified that how the subsidiary acquires the equity instruments needed to meet its obligation to its employees is a separate transaction from its transaction with its employees.

BC18 For the above reasons, the IFRIC reaffirmed its view that the transaction with the employees described in paragraph BC7(b) should be accounted for as cash-settled in the financial statements of the subsidiary.

Transfers of employees between group entities (paragraphs 9 and 10)

BC19 The IFRIC noted that some share-based payment arrangements involve a parent granting rights to the employees of more than one subsidiary with a vesting condition that requires the employees to work for the group for a particular period. Sometimes, an employee of one subsidiary transfers employment to another subsidiary during the vesting period, without the employee's rights under the original share-based payment arrangements being affected. The IFRIC reasoned in D17 that the change of employment from one group entity to another does not represent a new grant of equity instruments, because the equity instruments were granted by the parent (not the individual subsidiary). Therefore, the IFRIC proposed in D17 that the subsidiary to which the employee transfers employment should measure the fair value of the services received from the employee by reference to the fair value of the equity instruments at the date those equity instruments were originally granted to the employee by the parent.

BC20 The respondents to D17 generally supported this proposed treatment. Some respondents also asked the IFRIC to clarify the following two points:

(a) whether the transfer of employees between group entities would be considered as a failure to satisfy a vesting condition in the financial statements of the subsidiary from which the employees transferred employment (ie whether that subsidiary should reverse the charge previously recognised in respect of the services received from such employees); and

(b) after the transfer of employment, if an employee leaves the group during the vesting period, whether each subsidiary should reverse the charge previously recognised in respect of the services from that employee during the vesting period.

BC21 The terms of the original share-based payment arrangement require the employees to work for the group, rather than for a particular group entity. Thus, the IFRIC in its redeliberations reaffirmed its view that the change of employment should not result in a new grant of equity instruments in the financial statements of the subsidiary to which the employees transferred employment. For the same reason, the IFRIC concluded that the transfer itself should not be treated as an employee's failure to satisfy a vesting condition. Thus, the transfer should not trigger any reversal of the charge previously recognised in respect of the services received from the employee in the financial statements of the subsidiary from which the employee transfers employment.

BC22 The IFRIC noted that IFRS 2 paragraph 19 requires the cumulative amount recognised for goods or services as consideration for the equity instruments granted to be based on the number of equity instruments that eventually vest. Accordingly, on a cumulative basis, no amount is recognised for goods or services if the equity instruments do not vest because of failure to satisfy a vesting condition other than a market condition as defined in IFRS 2 Appendix A. Applying the principles in IFRS 2 paragraph 19, the IFRIC concluded that when the employee fails to satisfy a vesting condition other than a market condition, the services from that employee recognised in the financial statements of each subsidiary during the vesting period should be reversed.